

October 25, 1993

LETTER OF TRANSMITTAL

I am pleased to transmit to you the Commodity Futures Trading Commission's Study of Swaps and Off-Exchange Derivatives Trading as required by the Conference Report to accompany P.L. 102-546, the Futures Trading Practices Act of 1992. The Conference Committee requested the study in order to provide Congress with information to assist it in its consideration of future legislation relating to the markets for derivative products. The study includes information on business transactions and market participants; the information is provided consistent with the Commission's discretionary authority under section 8(b) of the Commodity Exchange Act.

Through this report, the Commission has attempted to provide an overview of derivative products found in today's marketplace and their attendant risks, as well as a survey of regulatory controls and risk management practices currently in effect in the United States. In its recommendations, the Commission has endeavored to identify areas of concern to be addressed in any future attempts to impose additional legal or regulatory safeguards and to ensure the integrity of the over-the-counter derivatives market. During the development of this study, the Commission consulted with representatives of the Securities and Exchange Commission and the Board of Governors of the Federal Reserve Board.

Copies of this submission also are being transmitted to all Members of the Conference Committee on P.L. 102-546. The Commission looks forward to working with you in the months ahead on the many issues addressed in the study.

Respectfully Submitted,

Sheila C. Bair
Acting Chairman

EXECUTIVE SUMMARY

The Conference Committee considering the CFTC's 1992 reauthorization legislation directed the agency to conduct a study of over-the-counter (OTC) derivative markets to determine the need, if any, for additional regulation of these markets, to analyze the public policy implications of two recent court decisions, and to consider the appropriateness of a single federal regulator for futures, securities, and OTC derivatives. Pursuant to this directive, the following Report was prepared by the Commission, in consultation with the Securities and Exchange Commission (SEC) and Board of Governors of the Federal Reserve Board (Fed or FRB).

The Report's central conclusion is that while no fundamental changes in regulatory structure appear to be needed at this time to address issues presented by the growing use of OTC derivatives, greater coordination among federal financial regulators would help assure that federal oversight remains adequate. Finding that the "systemic and public policy issues suggested by these products are not confined to any single market or the province of any one regulator," the Report recommends the establishment of an interagency council to consider common approaches to such issues as market information access, transparency, internal management controls, and the development of clearing facilities for OTC derivatives.

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A detailed summary of the Commission's findings and recommendations follows.

A. Size and Scope of the OTC Derivatives Markets

The Report provides an overview of the OTC derivative markets, including a quantitative characterization of their size and scope. Among the Report's key findings:

- o Market Size: The widespread use of notional principal in "sizing" the OTC derivatives market may grossly overstate total risk exposure because, for many common OTC derivatives transactions, notional principal is used only to calculate payments between counterparties and is never exchanged. Thus while available sources indicate that total notional principal in the interest rate and currency swap markets approached \$5 trillion at year-end 1992, the true risk exposure in these markets can be assumed to be only a small fraction of that amount.
- o Growth/Nature of Market: OTC derivatives have grown rapidly by any measure. The market for swaps appears to be almost entirely intermediated by institutions that act as dealers.
- o Swap Dealers: As of year-end 1991, the number of U.S. swap dealers with notional principal exceeding \$10 billion stood at 20. Of U.S. dealers, commercial bank positions were three to five times larger than those of non-banks or U.S. units of foreign dealers. Information provided by the Securities and Exchange Commission indicates that aggregate notional principal held by major U.S. broker-dealer affiliates on interest rate and, currency swaps and forex forwards roughly equaled the aggregate notional value of these dealers' futures positions.
- o End-Users: Based on available information, end-users of interest rate and forex derivative products appear to consist primarily of commercial banks and corporate financial subsidiaries (25%), followed by corporations (20%), regional banks (18%), and non-dealer foreign banks (16%). A few large U.S. end-users tend to account for a sizeable proportion of total industry notional principal.

The Report also notes that a threshold issue in considering the size and nature of the markets in OTC derivatives is that comprehensive, standardized data about OTC derivative products and those who use them are currently unavailable. One reason for this is that OTC derivatives market participants are subject to varying degrees of regulatory oversight and, thus, to different disclosure obligations. However, the available data is adequate to draw some basic conclusions, but includes gaps suggesting a need for further study.

B. Potential Risks Presented by Swaps and Other OTC Derivatives and Corresponding Recommendations

The Report points out that potential systemic risks, including those associated with individual participants (such as credit risk), and those more generally associated with OTC derivatives trading (such as lack of transparency), have been identified by numerous domestic and international regulators, and other interested parties. The Report summarizes these risks, and describes steps that have been taken by regulators and market participants to address them.

At this point, existing regulatory structures appear adequate to address issues raised by the growth in OTC derivatives markets. However, given that many of the issues raised to date are clearly interagency in nature, benefits could be reaped from greater communication and coordination among regulators with an interest in these markets. This effort would supplement, rather than supplant, the ongoing efforts of these regulators. Accordingly, the interagency council being recommended by the Commission would identify and consider common regulatory issues raised by OTC derivative products. Specifically, the CFTC recommends that such a council's agenda consist of the following issues:

1. Information Access. Perhaps the most pressing issue is the difficulty of obtaining comprehensive information about OTC derivative markets. An early focus of regulators' efforts should be identification of information gaps and data needs; e.g., what information or statistics are needed; what information is available and where such information is located; how information currently collected under risk assessment, capital or other authorities of the various regulators could be more standardized; whether more explicit lead regulator-type arrangements for the collection, exchange and monitoring of information

could improve its usefulness and accessibility; and the extent to which existing authorities are sufficient as to unregulated end-users and unregistered or foreign entities performing intermediary functions.

2. Pricing, Disclosure and Risk Valuation Issues. Another issue that federal regulators may wish to review is the relative lack of transparency in OTC derivatives markets, specifically, whether opacity adversely affects the management of risk. Additionally, regulators could examine the adequacy of financial disclosure by the various types of participants in these markets.

3. Internal Controls. Federal regulators may also wish to consider how they best can encourage the extension of basic risk control measures to end-users through guidance to regulated participants.

4. Clearing Facilities for OTC Derivatives. Proposals for clearing various OTC derivatives raise a number of issues appropriate for interagency discussion due to intermarket linkages between clearing systems, the intermarket interests of major participants, and participation by firms in multiple markets.

5. Scope of Regulatory Oversight. Though the Commission is not recommending additional regulatory controls over OTC derivatives at this time, the interagency council may wish to consider issues raised by the presence of dealers in OTC derivative markets that are not otherwise subject to federal regulatory oversight.

C. Public Policy Implications of **A-Mark** and **Tauber** Decisions

1. A-Mark. The Commission intends to carefully monitor how this decision is used by litigants and interpreted by courts, but does not believe the Commission's or the states' law enforcement efforts will be significantly hampered by the decision.

2. Tauber. In view of the prevalence of litigation over the scope of the Treasury Amendment, and the courts' lack of unanimity to which the recent Court of Appeals opinion contributes, the Commission will consider recommending to Congress legislation that would affirm the CFTC's view that the Treasury Amendment does not extend to the sale of futures and options on foreign currency to the general public.

D. Analysis of a Single Regulator for Derivative, Futures and Securities

The Report's analysis of the single regulator issue focuses primarily on issues raised by a merger of the CFTC and SEC. In the Commission's view, it is unlikely that the anticipated benefits of combining

the functions of the CFTC and the SEC into one agency would outweigh the anticipated costs. Merging the CFTC and the SEC would leave unaddressed the emerging issues concerning OTC derivatives which are the primary focus of the Report because OTC derivatives encompass products unregulated under either agency's regulatory framework. The systemic implications of OTC derivatives relate to the responsibility of bank regulators to oversee the activities of financial institutions involved with the products as well. The CFTC believes that the cross-market concerns about these products could best be addressed by establishment of the recommended interagency council encompassing the SEC, CFTC, and bank regulators to supplement the agencies' current efforts at cooperation, information sharing, and harmonization of regulatory efforts.

INTRODUCTION

By any measure, the worldwide growth of the over-the-counter (OTC) markets in derivative products during the past decade has been extraordinary. This growth has fundamentally changed financial management by providing increasingly novel and flexible tools for the efficient allocation and management of risks. With the recognition of these important benefits of derivative products also has come an increasing need to consider the implications of these products for the financial markets and the public interest at large. As a result, during this period, lawmakers and regulators from the United States and abroad have increasingly found it necessary to focus on the legal and regulatory issues presented by these markets. In this regard, the Commodity Futures Trading Commission (CFTC or Commission) has been directed by the Conference Committee that considered the Futures Trading Practices Act of 1992 (FTPA), Pub. L. No. 102-962, 106 Stat. 3590, to conduct this study of OTC derivative products and to report the results of its study to Congress. The Conference Committee requested the report in order to provide Congress with information to assist it in its consideration of the need for future legislation relating to the markets for derivative financial products.

The Conferees' request for this report followed years of deliberation by both Congress and the Commission concerning the legal status and appropriate regulatory treatment of OTC derivatives such as swaps agreements and hybrid instruments. These Congressional deliberations culminated in the enactment of the FTPA. Among other things, the FTPA granted the Commission authority, in appropriate circumstances, to grant exemptions from the requirements of the Commodity Exchange Act (CEA),¹ including the requirement that futures contracts be traded only on Commission-designated exchanges. Further, the FTPA specifically authorized the Commission to use that exemptive authority promptly to provide legal certainty to swap agreements and hybrid instruments. At the same time, with a view to the future, the Conferees directed the Commission--with the cooperation of and in consultation with the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System (Federal Reserve Board)--to conduct this study specifically to determine:

- (1) the size, scope, activities, and potential risks presented by the markets for swaps and other off-exchange derivative financial products;

¹ 7 U.S.C. § 1 et seq.

- (2) the need for additional regulatory controls that should be applicable to these products;
- (3) how any such regulatory controls could be implemented in a cost-effective manner;
- (4) the public policy implications of the decisions in Krommenhoek v. A-Mark Precious Metals Inc., 945 F.2d 309 (9th Cir. 1991) and Laszlo N. Tauber, M.D. v. Salomon Forex Inc., 795 F. Supp. 768 (E.D. Va. 1992), aff'd No. 92-1406 (4th Cir. October 18, 1993); and
- (5) whether a single federal regulatory agency should regulate the exchange or off-exchange trading of, and markets for, futures, options, swaps, derivative products and securities.

The Conferees directed the Commission to include in the report of its study any recommendations it had concerning the regulation of trading in the studied products.

As Congress and the Conferees were aware, the Commission had devoted substantial resources prior to the enactment of the FTPA to addressing the legal and regulatory issues raised by the evolving OTC derivatives markets. Beginning in the late 1980's, the Commission began to see an increasing number of innovative off-exchange transactions that exhibited some of the economic or legal characteristics of futures contracts or commodity options, but which were designed to be traded outside the exchange environment. With the creation of these products, questions arose concerning the applicability of the CEA. Since that time, the Commission has specifically attempted to foster the development of these emerging products, where possible. In this endeavor, the Commission's goal has been, and continues to be, to support innovation within the framework of the CEA. The Commission has worked closely with other agencies to avoid regulatory gaps and to reduce regulatory uncertainties that may have existed with regard to these new products and that may have stood as an impediment to financial innovation.

For several years prior to the enactment of the FTPA, the Commission made use of its then-existing authority in its efforts to accommodate the expanding OTC derivatives markets. For example, with regard to swap agreements, the Commission in July 1989 adopted and published a policy statement which noted that most swaps, although possessing elements of futures or option contracts, were not appropriately regulated under the CEA or the Commission's regulations. The policy statement thus recognized a non-exclusive "safe harbor" for swap agreements satisfying certain specified conditions.

With regard to hybrid instruments, the Commission, also in July 1989, adopted rules regarding

certain hybrid instruments that combined characteristics of commodity options with debt, preferred equity or depository interests. The rules established an exemption from Commission regulation for these types of instruments based upon the limited nature of their commodity option component and deference to other federal and state regulatory frameworks applicable to their non-commodity component. In addition, in January 1989 and April 1990, the Commission issued, and subsequently re-issued in refined form, a statutory interpretation applicable to hybrid instruments that combine characteristics of futures contracts or commodity options with debt or depository instruments. The Commission essentially determined that the commodity component of instruments covered by the statutory interpretation was relatively insignificant or de minimis in nature and that they would be deemed to be excluded from Commission regulation.

Since the enactment of the FTPA, the Commission has used its new exemptive authority to further clarify the legal status of swaps and hybrids. In this regard, in January 1993, the Commission issued rules generally exempting certain swap agreements from most Commission regulations and amended its rules exempting certain hybrid instruments. The Commission has also received several petitions for exemption from regulation submitted pursuant to the exemptive authority provisions of the FTPA. One petition, involving certain contracts between commercial participants for the deferred purchase or sale of energy products, was generally granted by Commission order in April 1993. Currently, the Commission is considering a petition for exemption from the Chicago Mercantile Exchange concerning the purchase and sale of certain of its now exchange traded futures and options foreign currency contracts, and a petition from the Chicago Board of Trade seeking an exemption for a "professional trading market" for trading in any instrument of any board of trade.

This Report consists of six chapters as follows:

	Chapter I	The
	Nature, Size and Scope of the OTC Derivatives Markets	
Chapter II	Overview of the Regulatory Status of OTC Derivative Transactions	
Chapter III	Potential Risks Arising from OTC Derivative Transactions	
Chapter IV	Recommendations	
Chapter V	The Public Policy Implications of the <u>A-Mark</u> and <u>Tauber</u> Decisions	

Chapter VI

Analysis of the Costs and Benefits of a Single Regulator for
Derivatives, Futures and Securities

A separately bound volume of working papers containing detailed background material prepared by the Commission's staff accompanies the report. The seven working papers cover the following areas:

Working Paper 1	Size and Scope of the OTC Derivatives	Market
Working Paper 2	Summary of Interviews	
Working Paper 3	Regulatory Overviews	
Working Paper 4	Default Case Studies	
Working Paper 5	Accounting Issues	
Working Paper 6	Descriptions of Derivative Product	Companies
Working Paper 7	A. Glossary of Terms B. Bibliography C. Survey of Literature	

The CFTC staff undertook the following research in the preparation of this report;

- o In-depth analysis of several extensive databases relating to OTC and exchange-based derivatives market activity and participants;
- o Wide-ranging interviews of 25 U.S. OTC market participants encompassing fourteen dealers and eleven end-users, four software providers, two major credit rating agencies and one regulatory agency with supervisory authority over one class of interviewee;
- o A detailed survey of market authorities in Canada, France, Germany, Japan, Hong Kong and the United Kingdom on the regulatory status of OTC derivative products in these jurisdictions;
- o Review of a large body of existing literature on the OTC derivatives markets, including academic

papers and books, U.S. and foreign government reports, and industry reports; and

- o Review of existing domestic financial regulatory structures, including statutes and regulations, to determine their interface with OTC derivatives markets.

In addition, the Commission consulted with and received the full cooperation of the SEC and the Federal Reserve Board in preparing this report.

Through this report and its appended working papers, many sections of which address complementary or overlapping issues, the Commission has attempted to provide an overview of derivative products found in today's marketplace and their attendant risks, as well as a survey of regulatory controls and risk management practices currently in effect in the U.S. In its recommendations, the Commission has addressed potential areas of concern which warrant further discussion.

CHAPTER I

THE NATURE, SIZE AND SCOPE OF THE OTC DERIVATIVES MARKETS

Introduction

The purpose of this chapter is to provide an overview of the markets for swaps and other OTC derivative products, including a quantitative characterization of their size and scope. The chapter identifies the major participants in these markets and the extent of their activities. In addition, data are presented which are relevant to important economic characteristics of these markets, including information on the maturity profiles and replacement costs of derivatives positions and the credit ratings of market participants.²

To provide a frame of reference, where possible, the information presented on the OTC derivatives markets is compared to analogous information that may be available for exchange-traded derivatives markets. Further, where available, data on both worldwide and domestic OTC derivatives markets are presented in order to take advantage of the broadest range of data sources. Most of the data presented on OTC derivatives activity is worldwide in nature, reflecting the international scope of these markets.

Although information on the markets for various OTC derivative products is presented, much of the discussion in this chapter centers on the markets for swaps. In part, this focus reflects the relatively greater amount of data available on the swaps markets than on other OTC derivatives markets. However, it also reflects the fact that swaps, while sharing many of the economic characteristics of derivative products that have existed for some time (e.g., futures and options), represent a new generation of derivative products the use of which has increased rapidly over a very short time period.

Data Sources and Limitations

Data presented in this chapter are drawn from several sources. The two principal sources for OTC derivatives data are surveys undertaken by the International Swaps and Derivatives Association, Inc. (ISDA), and the Handbook of Users of Off-Balance Sheet Instruments (published by Swaps Monitor

² The quantitative information on the OTC derivatives markets summarized in this chapter is taken from Working Paper 1.

Publications, Inc.). In the ISDA surveys, most ISDA primary members, all of whom function as derivatives market dealers, voluntarily provide data on their semi-annual swaps market activity and year-end swaps market positions. Data from the Handbook of Users of Off-Balance Sheet Instruments are derived from publicly available financial statements (and therefore reflect activities of only publicly traded firms) and pertain to outstanding positions in seven different derivative instruments (six OTC instruments plus futures). Other data sources, used to a lesser degree, are The World's Major Swaps Dealers (also published by Swaps Monitor Publications, Inc., and containing data derived from publicly available financial statements), the Bank for International Settlements 1992 documents Central Bank Survey of Foreign Exchange Market Activity and Recent Developments in International Interbank Relations prepared by the Working Group established by the Central Banks of the Group of Ten Countries, Bank for International Settlements, Basle, October 1992 (the Promisel Report), and the Federal Reserve Board's Consolidated Financial Statements for Bank Holding Companies (the FRY-9c reports).

Data on exchange traded derivatives are obtained from reports of the Futures Industry Association and from various CFTC-maintained data bases.

The principal limitations of the data available on the OTC derivatives markets can be summarized as follows. First, reporting and disclosure practices vary significantly across borders and across participants. As a result, comparisons across countries or even across firms within a country may be subject to some error. Second, data generally are available only for broad categories of derivative products and market participants. The most extensive data pertain to interest rate and currency swaps and to dealers and broad categories of end-users. Very little information exists on the extent of activity in OTC equity options and swaps and commodity swaps or by non-depository financial institutions such as pension funds and investment companies. These limitations are due in part to the varying degrees of regulatory and self-regulatory oversight to which OTC derivatives market participants are subject, along with the sensitive nature of certain detailed information relating to participants' OTC derivatives market activities.

An additional limitation is that, for the most part, only data on notional principals are widely available. As with calculations that show the underlying contract value of outstanding futures contracts,

notional principal is less than ideal for characterizing certain important aspects of the markets, particularly risk exposure.³ This is because in many OTC derivatives transactions, notional principal is the nominal value used to calculate contract payments. For example, in an interest rate swap, notional principal is used only to calculate the interest payments between counterparties; the principal amount itself is never exchanged.⁴ As a consequence, risk exposure will tend to be a small fraction of the notional principal.⁵

Partly for these reasons, market statistics based on different sources sometimes differ by fairly large amounts. Despite these limitations, however, useful information can still be gleaned from analysis of these data. For example, notional principal data generally will provide reasonable approximations of the relative scale of activity across countries or business units and over time unless biases and errors in the data vary in a systematic fashion according to these breakdowns.

The Nature of the OTC Derivatives Markets

In general, derivatives are distinguished from other financial instruments according to whether their primary use is for shifting market risk (as opposed to raising capital, for example). The basic types of financial instruments that typically are included in the term "derivatives" are futures, forwards, options and swaps.⁶ These instruments can be based on currencies, interest rates, securities, physical commodities or indexes representing values of groups of such instruments and assets.⁷

³ In this regard, the order of magnitude of a futures position's risk exposure is more accurately gauged by reference to the margin requirements imposed by futures exchanges than by underlying contract value. The values of such margin tend to represent anywhere from 0.5% to 10.0% of a futures position's underlying contract value. No such convenient measure of an OTC derivative position's risk exposure is available.

⁴ This is generally true for all types of swaps except foreign currency swaps in which principal amounts are exchanged. It is also noted that all futures contracts which are not cash settled require the making or taking of delivery at expiration, that is, effective exchange of the underlying contract value. However, the vast majority of futures contracts outstanding at any given time are settled by offset rather than by delivery.

⁵ Additional problems in estimating risk exposure from notional principal data are that notional principal fails to account for trades that offset economic exposure and fails to account for contract-specific features (e.g., maturity) which imply differential riskiness.

⁶ Strictly speaking, to the extent that forward contracts are utilized for merchandising, they are not derivatives since their primary use as such is the deferred transfer of ownership. However, following previous studies on OTC derivative products, we include the generic term "forwards" within the term "derivatives" without further distinction concerning their intended use. These and other OTC products, along with other technical terms used herein, are defined in the glossary contained in Working Paper 7A.

⁷ Hybrid instruments contain elements of depository instruments or securities and futures or commodity options. Some of these instruments enable issuers to both raise capital and to manage risk. For example, an oil company can issue a hybrid bond that directly ties principal repayment to the price of oil.

Derivative instruments in their various forms provide significant benefits to market participants. For the past 130 years, futures contracts on agricultural commodities have permitted participants in agricultural markets to reduce their exposure to price changes by establishing positions in the futures markets opposite their cash market positions or obligations.⁸ The introduction, beginning in the early 1970's, of futures and exchange-traded options on financial instruments such as stocks, bonds, and foreign currencies provided the same opportunities to financial institutions and corporations facing uncertain price exposure in these markets. In addition to the direct benefits of hedging to users of futures and option contracts, others involved in the production and distribution of commodities and financial instruments benefit from the availability of continuous, well-publicized prices discovered in futures and exchange-based option markets.

More recently, the offering of derivative products has broadened. In the past decade, OTC options and swaps have been added to the mix of derivative instruments available to market participants. Many of the benefits associated with these contracts are similar to those associated with futures contracts. That is, they allow users to manage price exposure risk. However, they differ from futures in that they permit users to fine tune their risk management activities to a greater degree than is easily accomplished with more standardized futures contracts or exchange traded options.⁹ An example of the use of an interest rate swap will help illustrate this point. An interest rate swap is a financial transaction in which two counterparties agree to exchange, at specified intervals and for a set term, streams of payments based on specified interest rates calculated on an agreed-upon notional principal amount. Typically, one party will agree to pay the other party a stream of payments based on a fixed interest rate while the latter party agrees to pay the former party a stream of payments based on a variable interest rate.

Since such a bond would require the firm to pay more when it is in a position to do so and less when it is not, it represents a better credit risk and therefore may be issued at a lower interest rate.

⁸ The use of forward contracts in agriculture and in commodity markets has an equally long history as an integral part of the product distribution process.

⁹ OTC derivatives differ from futures in another functional respect that is partly related to their non-standardization. Since their pricing terms are not widely disseminated, swaps and most other OTC derivatives generally do not serve a price discovery function. An important exception is the interbank market in foreign currencies, from which quotes on certain forward rates are readily accessible from sizeable commercial banks.

Assume that a small firm, the Acme Corp., has issued a note with a principal amount of \$1.5 million and a fixed interest rate of 8.0% payable semiannually over a period of 5 years. If at some point subsequent to the issuance of the note, the Acme Corp. becomes concerned that interest rates will fall over the remaining life of the note (and that it will therefore be paying higher than contemporaneous market rates for its funds), the firm may consider ways in which it may effectively transform its fixed rate liability into a floating (or variable) rate liability.

One way of doing this is to buy a series of Eurodollar futures contracts, each of which matures on one of the note's interest payment dates. Because Eurodollar rates (specifically the London Interbank Offered Rate, or LIBOR) vary inversely with the value of a Eurodollar futures contract, if interest rates do indeed fall, profits from the Eurodollar futures position can be used to offset the original 8.0% fixed interest payment. This strategy, however, has two limitations. One limitation is that the underlying (or "notional") principal value of a Eurodollar futures contract (\$1.0 million) does not conform to the principal value of the Acme Corp.'s note. The other limitation is that the maturity dates for Eurodollar futures contracts are not likely to line up precisely with the firm's interest payment dates.

Both of these limitations may be addressed if the Acme Corp. can enter into a swap agreement in which it pays a variable interest rate and receives a fixed interest rate based on a notional principal of \$1.5 million with pay/receive dates set to correspond to the interest payment dates of the note. If the variable interest rate the firm pays is, say, LIBOR + 0.5%, and the fixed interest rate it is paid is 5.0%, then the firm's total cost of funds using the swap will be

$$(8.0\% - 5.0\%) + \text{LIBOR} + 0.5\% = 3.5\% + \text{LIBOR}.$$

This will be less than the original 8.0% interest cost as long as LIBOR averages less than 4.5% on the swap payment dates.

Participation in the OTC derivatives markets is dominated by financial institutions and large corporations, with the former group including primarily banks and broker-dealers. Following the nomenclature that has become common in this area, it is useful to divide market participants into two broad categories: end-users and dealers. End-users employ derivatives contracts to facilitate the

management of financial risks and opportunities that arise in the course of their business. Dealers are distinguished from end-users by their readiness to make two-way markets in OTC derivatives, thereby providing end-users (and other dealers) with the derivatives positions they seek. In performing this market-making function, they act as principals rather than as agents in transactions.

Information obtained from interviews of market participants conducted in connection with the preparation of this report along with previous studies of the OTC derivatives markets suggest that the market today is almost completely intermediated; that is, virtually all end-user trades go through dealers. In addition, dealers trade not only with end-users, but also with other dealers. Moreover, in this market, interdealer trades are not necessarily related to or triggered by underlying customer trades. Thus, demand in this market arises not just from end-users, but also from dealers themselves.

Quantitative Characterization of the OTC Derivatives Markets

Market Size

Two metrics of market size commonly used in analysis of the OTC markets are the notional principals of outstanding contracts (measured at a point in time) and the turnover or trading activity (measured over a period of time). The interest rate and foreign currency swaps markets have been experiencing fairly steady growth in both measures.

Figure 1 shows that the worldwide outstanding notional principals of interest rate and currency swaps have grown from \$0.68 and \$0.18 trillion, respectively, at year-end 1987, to over \$3.9 and \$0.9 trillion at year-end 1992. By way of comparison, the notional value of open U.S. interest rate and currency futures contracts has grown from \$0.41 trillion at year-end 1987 to \$1.35 trillion at year-end 1992.¹⁰

Interest rate and currency swap activity, measured both in terms of new notional principal and number of new contracts originated per semiannual period, also has grown rapidly as shown in Figure 2. Between 1990 and 1992, the annual number of new interest rate and currency swap contracts originated

¹⁰ As a qualification of such comparisons, it is noted that average swap contract sizes (measured in terms of notional principals) tend to range anywhere from 20 to 400 times as large as exchange-traded contract sizes (measured in terms of underlying or notional contract value).

increased from 63,000 to 104,000 for an annualized growth rate of 28.5%. For purposes of comparison, the number of derivatives contracts traded on exchange markets over the period 1990 through 1992 is graphed in Figure 3. It shows, by geographic sector, total worldwide exchange-based trading in interest rate and currency futures and options. Worldwide annual volume has increased from about 307 million contracts in 1990 to 441 million in 1992, an annualized growth rate of 19.9%. This compares to a growth rate in the number of interest rate and currency swap contracts of 28.5% over the same period.

A breakdown of the swap data by the underlying currency illustrates the international dimensions of the swap market. Figure 4 shows that the U.S. dollar is overwhelmingly the dominant individual currency for interest rate swaps, but less so for currency swaps; the distribution of notional principals across currencies is much more uniform for currency swaps. Starting from smaller bases, growth rates for non-U.S. currencies have been greater over the last few years.

A range of other OTC interest rate options--caps, floors, collars and swaptions--have developed alongside the interest rate swap market. As reported by ISDA, at year-end 1991 the aggregate notional principals of these instruments stood at \$577 billion.

OTC derivatives markets in commodities and equities are of a more recent vintage than the OTC interest rate and currency markets and data on these markets are only now becoming available. Year-end 1992 data as reported by ISDA are shown in Figure 5. Outstanding notional principals of OTC equity swaps and options stood at \$75 billion while notional principals in OTC metals and energy derivatives amounted to \$30 billion.

Market Participants and Their Derivatives Usage

Swap Dealers The World's Major Swaps Dealers reports that, as of year-end 1991, the number of dealers worldwide each with an outstanding notional principal exceeding \$10 billion in interest rate and currency swaps was 39, for a grand total of \$3.7 trillion in notional principal. Of these, 20 were U.S.-based institutions, 10 were based in Europe, four in Asia, and five in Canada.

An examination of swaps positions of U.S.-based dealers (U.S. commercial banks, U.S. non-banks and U.S. branches of foreign dealers) showed that commercial banks' positions were from three to

five times larger than those of either non-banks or U.S. units of foreign dealers as of the end of 1992.

Figure 6 shows the interdealer proportion of the total notional principal (interdealer plus end-user) depicted in Figure 1. For all currencies taken together, the interdealer proportion stands at close to 50% for interest-rate swaps and at about 27% for currency swaps, as of year-end 1992.

Information obtained from the Securities and Exchange Commission indicates that the aggregate notional principal of positions in interest rate swaps, foreign currency swaps and foreign exchange forward contracts held by major U.S. broker-dealers in 1992 was approximately equal to the aggregate notional value of these dealers' futures positions in 1992.

End-Users Aggregate, worldwide notional principals for three groups of end-users, namely, financial institutions (including commercial banks, thrift institutions, insurance companies and financial subsidiaries of corporations), government agencies and corporations, are shown in Figures 7 and 8 for interest rate swaps and currency swaps, respectively. The total end-user interest rate swap notional principal has always been greater than total end-user currency swap notional principal, although the annualized growth rates are approximately the same (34% and 33% respectively). The distribution of participation by the three groups is different for interest rate and currency swaps. As of year-end 1991, financial institutions, government agencies and corporations constituted 56%, 10% and 34%, respectively, of the interest rate swap end-user market, and 43%, 16% and 41%, respectively, of the currency swap end-user market. Additional analysis of the data underlying figures 7 and 8 established that end-user notional principals for both interest rate and currency swaps have grown much more rapidly in Europe and Asia than in the United States.

Figures 9 and 10 show aggregate notional principals of U.S. end-users, by user category, for several interest rate products (the sum of swaps, interest rate caps and forward interest rate agreements) and foreign exchange products (the sum of currency swaps, currency forwards, and currency options). At year-end 1992, financial institutions consisting primarily of large domestic commercial banks and financial subsidiaries of corporations accounted for 25% of total end-user notional principal in interest rate products; they are followed by corporations, regional banks, and non-dealer foreign banks, which respectively

accounted for 20%, 18% and 16%. End-user notional principals in currency products are generally lower than for interest rate products for all user categories. Non-dealer foreign banks and corporations have the largest outstanding notional principals, followed by regional banks and non-depository financial institutions (other than insurance companies). Additional analysis of the data underlying these graphs established that a few large U.S. end-users tend to account for a sizeable proportion of the industry notional principal. That is, the end-user market consists of numerous entities with relatively small positions and a few entities with relatively large positions.

Risk-Related Market Characteristics

Maturity. Longer maturities are often taken as indicative of greater risk. For example, the prices of long-term bonds are more sensitive than the prices of short-term bonds to changes in interest rates. Moreover, for many assets, default probability is likely to increase with increasing years to maturity.

The outstanding notional principals, categorized by years to maturity, for interest rate and currency swaps are shown in Figures 11 and 12, respectively, for the year-ends 1987 through 1991. The data suggest a shift toward shorter maturities for interest rate swaps over this period.¹¹ Interest rate swaps maturing in less than a year have grown at an annualized rate of 58%, compared to a growth rate of 15% for swaps with maturities exceeding 8 years (the counterpart figures for currency swaps are 67% and 25%).

Replacement Costs Commercial banks provide information on the gross replacement costs in interest rate and exchange rate contracts in the Federal Reserve's Consolidated Financial Statements for Bank Holding Companies (the FRY-9c reports).¹² As noted by industry sources, gross replacement costs will tend to overstate the true credit exposure; however, these are the only data available at present.

For non-dealer banks, the aggregate replacement costs have been \$12 billion, \$8 billion and \$8 billion for year-end 1990, 1991, and 1992, respectively. For the dealer banks, the corresponding figures are

¹¹ This finding is consistent with the Promisel Report at 11.

¹² The replacement cost is the estimated cost of replacing various OTC derivatives positions at prevailing interest rates and exchange rates, should the counterparties default. Only positive values are reported. These are "gross" replacement costs, because they do not take into account bilateral netting of multiple derivative contracts with a single counterparty. The following are excluded from these computations: futures contracts, spot foreign exchange contracts with original maturities of 14 days or less, and written options. Purchased options are included, and commodity contracts are grouped with exchange rate contracts.

\$92 billion, \$144 billion, and \$141 billion. To capture scale differences, it is useful to express these figures relative to the book value of assets. The year-end average values of this measure (i.e., the aggregate value of replacement costs divided by the aggregate book value of assets divided by the number of banks) are shown in Figure 13 for non-dealer banks and in Figure 14 for dealer banks. At year-end 1992, total gross replacement costs of the "typical" dealer bank amounted to about 9% of the book value of assets while the same figure for non-dealer banks was about 0.6%.

Credit Ratings. Bond ratings assigned by Moody's and Standard & Poor's have a long history in investment analysis as indicators of credit risk. The Handbook of Users of Off-Balance Sheet Instruments-U.S. Edition provides the year-end 1992 rating assigned by Moody's and Standard & Poor's for a wide variety of U.S. entities. For reasons of tractability, the ratings have been grouped into four classes: AAA and AA (denoted as Better than A), A, below A, and No Rating (note that the absence of a rating carries no connotations of a weak rating). Figure 15 shows the total notional principal in each rating class, for all OTC contracts. Only a comparatively small proportion of the total notional principal resides with users rated lower than A.

CHAPTER II

OVERVIEW OF THE REGULATORY STATUS OF OTC DERIVATIVE TRANSACTIONS

Introduction

The term "derivatives" potentially includes all interests and instruments, whether or not traded on an organized futures or securities exchange, that are contracts specifying rights and obligations based upon, and that derive their value from, the performance of some underlying instrument, investment, currency, product, index, right, service or rate. Derivative products permit the efficient transfer and allocation of risks. As such, they may lower the cost of financial intermediation activities and reduce or limit price exposure in commercial transactions. The development of derivative products in financial instruments is a relatively recent innovation. This development is an outgrowth of, among other things, both modern financial theory (including portfolio theory, present value analysis and option pricing) and deregulation of interest and exchange rates.

It is in the nature of the financial innovation process to unbundle and repackage the elements of financial instruments to create new instruments.¹³ Historically, individual OTC commercial transactions fostered the development and use of more centralized markets. This has been true even in the context of financial instruments. For example, the banking community's OTC forward rate agreement and the Chicago Board of Trade's exchange-traded futures on the Treasury Bond developed at about the same time. The development of OTC derivatives permits the counterparties to reconfigure financial instruments and to create synthetic instruments to meet particularized risk shifting or risk management needs rather than be limited by the standardized design of exchange-traded products.

The overall OTC derivatives "marketplace" encompasses a wide variety of types of transactions and customized products which generally lack the unifying characteristics of conventional markets. This marketplace includes, among other types of products, transactions in securities, for example OTC options on individual equities and stock indexes; transactions in hybrids, such as oil-indexed notes, which combine elements of familiar products such as securities and futures contracts that are traded and regulated

¹³ Bank for International Settlements, Recent Innovations in International Banking (April 1986).

separately in their disaggregated form; transactions which have elements of regulated futures contracts, but have been exempted from CFTC regulation subject to certain restrictions, e.g., swaps; and certain specialized "forward" markets, such as the interbank market in foreign currency and the Brent oil market, which are used for risk shifting and speculation in prices as well as for the transfer of a particular product.

No single regulatory framework governs the many types of instruments cognizable as derivative products. From a regulatory perspective, derivatives range from products that are subject to comprehensive futures or securities regulatory frameworks, traded on centralized exchange markets subject to audit trail, price transparency, trade practice, customer funds and anti-fraud and anti-manipulation protections, to historically unregulated transactions such as forward contracts.¹⁴

The OTC derivative regulatory landscape is complicated by multiple types and levels of regulation, depending on the product and the manner of concluding transactions therein. Further complexity results from the significant use of OTC derivatives by entities which are themselves subject to one or more regulatory regimes, either as intermediaries (e.g., commercial banks and investment banks) or as end-users (e.g., pension funds and investment companies). Because derivative OTC transactions grew out of unbundling price differentials from commercial transactions, it is not surprising that some derivative transactions are conducted directly between unregulated counterparties or corporate end-users. As a consequence, the mere fact that unregulated corporate end-users engage in frequent OTC derivative transactions does not in and of itself implicate regulatory concerns. Such end-user activity may be in the nature of commercial transactions and, as such, qualitatively different from intermediation, in that intermediation could involve extensions or guarantees of credit or custodianship of assets or concentrate risk.

The largely decentralized, privately negotiated, customized, bilateral contractual context of OTC derivatives transactions may, in many cases, be subject only to certain safe harbor criteria as to the conduct of and participants in the transaction and residual anti-fraud and anti-manipulation prohibitions. By

¹⁴ Forward transactions generally are considered to constitute "the sale of a cash commodity for deferred shipment or delivery." Section 1a(11) of the Commodity Exchange Act, 7 U.S.C. §1a(11).

contrast, exchange markets for futures and securities products are auction markets, open to the public, and subject to self-regulatory as well as federal regulatory oversight. They involve transactions in standardized products, effected by regulated intermediaries and settled by supervised clearing organizations, the prices of which are publicly disseminated.

The CEA¹⁵ which governs transactions in futures contracts and commodity options, and the federal securities laws, which govern transactions in securities, including securities options, are relatively comprehensive schemes for the regulatory oversight of exchange markets for those products and the intermediaries who operate in such markets. In the case of the SEC, the regulatory scheme also extends to primary offerings of securities.

Although the exchange regulatory model is a basic component of both regulatory systems, neither is confined to transactions occurring on centralized exchange markets. Both the CFTC and SEC regulatory frameworks currently contemplate less comprehensive regulation of certain essentially private transactions with accredited parties than for exchange trading or public securities offerings. These categories of reduced regulatory requirements are directly relevant to the OTC derivatives market.

Under the CEA, centralized trading of futures contracts and commodity options on CFTC-approved exchanges is the exclusive form of permissible trading, absent specific exemption. As previously noted, the CFTC received authority to grant exemptions from the exchange-trading requirement in late 1992.¹⁶ The exemptions from the exchange-trading requirement granted to date generally are based on the status or resources of the counterparties to the exempt transactions as well as characteristics of the transactions themselves. These exemptions provide broad relief from most other CFTC regulations and have been premised on a finding that they do not jeopardize the integrity of the marketplace or the public interest.

Similarly, the securities regulatory framework provides for a comprehensively regulated exchange environment. Traditionally, however, although the SEC applies a different level of regulation to off-exchange

¹⁵ 7 U.S.C. § 1 et seq.

¹⁶ Section 4(c) of the CEA, 7 U.S.C. §6(c), added by the Futures Trading Practices Act of 1992, grants the Commission broad authority to exempt any agreement, contract, or transaction (or class thereof) from any of the requirements of the Act except Section 2(a)(1)(B), 7 U.S.C. §2a, based upon, among other things, a determination that such exemption would be consistent with the public interest.

transactions, the securities laws have viewed OTC securities transactions as complementary to exchange trading and have encouraged their competition with exchange markets. For example, securities are traded over the National Association of Securities Dealers Automated Quotation System (NASDAQ), which is operated by the National Association of Securities Dealers (NASD) and is considered part of the national market system for securities transactions. However, despite differences between NASDAQ and national securities exchange markets, the NASDAQ market also is a regulated market with information reporting requirements, price discovery capability and market-making requirements.¹⁷ In addition to exchange regulation, the SEC framework includes regulation of primary public offerings of securities which contemplates product registration and disclosure requirements. Private placements of securities, such as privately-offered securities option transactions, which may be exempt from registration requirements nonetheless remain subject to anti-fraud, deception and manipulation prohibitions.

An Overview of the Origins of Financial Regulation

Domestic banking, securities and futures legislation developed independently and the resulting regulatory schemes are, therefore, oriented differently. Originally, securities legislation supported a primary capital formation market for the issuance of securities and secondary markets as a means of facilitating the transfer of securities. Along with regulating capital formation and secondary trading, the securities laws provided for the protection of investors. From their inception the securities laws distinguished between private transactions in securities and public offerings and contemplated private OTC markets in securities. Dealers who rendered quotes and made markets for customers have been regulated as market participants since adoption of the Maloney Act in 1938. Brokers who carried customer positions were also subject to regulation. Secondary exchange markets were a means of achieving an efficient market for the transfer of

¹⁷ See 56 Fed. Reg. 44,108 at 44,110 (September 6, 1991). In 1990, there were 4,706 securities in the NASDAQ system and the total volume for the year was 33.4 billion shares traded. *Id.* at 44109 n.7. The NASD as a "national securities association" is required to have rules designed to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade and is the "self-regulatory organization charged with policing the [OTC securities] market." 56 Fed. Reg. at 44,110. An issuer whose securities are quoted over the NASDAQ is required to meet certain requirements that correspond to listing criteria on exchanges. Generally, in order to be listed on the NASDAQ, there must be at least two registered market-makers for the security. Brokers and dealers that trade in the OTC market are required to register with the SEC.

individual issues, facilitated liquidity in shares, and were required to be regulated. The market itself was considered a public utility and maintenance of a continuous, efficient and orderly price was mandated. Amendments to the securities laws enacted in 1975 provided for the establishment of a national market system to, among other things, assure economically efficient execution of transactions and competition among brokers and dealers, among exchange markets and between exchange markets and markets other than exchange markets.¹⁸ National market system securities are those specified by the SEC by rule and include both exchange-listed and NASDAQ National Market securities.¹⁹

By contrast, the futures exchange markets do not exist to facilitate the transfer of ownership of a cash commodity. Futures markets developed to reallocate the risk in commercial transactions and facilitate discovery of the efficient price for commodities in general commerce. Unlike the federal securities regulatory framework, the main focus of futures transaction regulation was on transactions in the "secondary" exchange market reflecting that all futures transactions were required to be effected on a centralized exchange and that there is considered to be no "issuer" of futures contracts and thus no offering process comparable to that for securities. All futures transactions were required to be conducted in the public marketplace and thus included in the auction price. This centralization was considered important for the effective functioning of the markets as a price discovery mechanism, and much of the regulatory scheme was directed at the proper reflection of price. In general, subject to certain financial protections, futures markets were not required to be "continuous" and until recently, affirmative market-making obligations to maintain liquidity were foreign to such markets. Although all large market participants were required to report their positions, regulatory financial requirements were directed solely to agents (brokers) transacting on behalf of customers.

Exchange-traded stock and stock index options did not exist until the 1970's. At that time,

¹⁸ 1934 Act §11A, 15 U.S.C. §78k-1.

¹⁹ 17 C.F.R. § 240. 11Aa2-1 (1993). After adoption of the statutory "mandate" to create a national market system, facilities were developed providing for dissemination of price information (the "Consolidated Tape Association"), quotation information (the "Consolidated Quotation System") and an intermarket order routing system (the "Intermarket Trading System"). See the concept release regarding the SEC's U.S. Equity Market Structure ("Market 2000") Study, 57 Fed. Reg. 32,587, 32,591 (July 22, 1992) for a more detailed discussion of these facilities.

options on individual equities were listed and in subsequent years significant regulatory and legislative attention was directed to the appropriate regulation of such products. Unlike futures regulators, domestic securities regulators deem the clearing entity to be the issuer of exchange traded options.

Exchange markets, both securities and futures, characteristically have had regulatory or self-regulatory criteria relating to the financial capacity and accountability of members entering into transactions for themselves or for others. These were necessary because transactions in such markets are concluded anonymously, without the benefit of individual credit judgments concerning counterparties. In exchange markets for securities, the clearing agency assures delivery of an asset against payment; in most derivative markets, the clearing system guarantees the obligation to make daily payments of losses.

From the beginning, banking regulation generally treated credit and financial intermediation activities as transactional activities fundamental to banking. Such activities were addressed from the point of view of the integrity of the institution itself and its capacity to perform banking functions. Part of banks' basic business was the business of evaluating credit and making credit determinations. Historically, even so-called interbank market transactions generally were undertaken, not anonymously, but on a "name" or known credit basis. Bank regulators are generally described as regulating banks or financial institutions, not markets. In general, banks are regulated through supervisory review of safety and soundness, including assessment of liquidity, by limitations on certain "end-user" and "dealer" activities, by direct examination and by required capital.

The regulatory requirements which developed over the years in the financial services sector have been tailored to whether these services: (1) were privately or publicly offered, and by whom; (2) were concluded on a principal or agent basis, on or off an exchange; and (3) involved the commitment of funds to a custodian for investment or safekeeping. The development of OTC derivative markets has had to fit into this pre-existing regulatory framework.

The Current Status of Regulatory Review of OTC Derivatives

Tailored, credit judgment, risk shifting transactions did not readily lend themselves to exchange trading. Therefore, in order to permit such innovations, futures regulators had to revisit longstanding federal exchange trading requirements. Further, state anti-wagering and bucketshop laws, which were preempted for exchange activity, limited potential OTC activity. Within this statutory environment, the CFTC (1) determined, subject to anti-fraud and anti-manipulation prohibitions, to exempt certain transactions as more particularly described below conducted between appropriate counterparties on a bilateral basis; (2) identified certain transactions which are primarily the responsibility of other regulators, though exhibiting some futures- or options-like characteristics; and (3) began to consider what changes, incremental as well as more fundamental, might be made, consistent with the regulatory objectives of the CEA, to traditional exchange markets and clearing systems to accommodate nonconventional OTC products.²⁰ The CFTC has also indicated that it intends to review whether existing financial requirements appropriately value OTC options and whether existing capital requirements, which are intended to completely offset unsecured credit risk, can be modified.²¹ The CFTC is also in the process of developing risk assessment rules to

²⁰ On October 19, 1992, the Commission approved rules implementing the Chicago Board of Trade's (CBT) Project A automated order entry and matching system on which it anticipated listing non-futures products for trading. The proposal was published for comment in the Federal Register, 57 Fed. Reg. 6001 (February 19, 1992). The CBT currently is proposing to trade flexible options on various Treasury futures contracts. The proposal would allow counterparties to execute trades using a wider variety of exercise styles, expiration dates and strike prices than is currently available for standard options. See 58 Fed. Reg. 52,278 (October 22, 1993). See also the Commission's notice of petitions for exemption and request for comment regarding the Chicago Mercantile Exchange's petition for exemptive relief with respect to its Rolling Spot Contracts and the CBT's petition for a "professional trading market exemption." 58 Fed. Reg. 43,414 (August 16, 1993).

²¹ 58 Fed. Reg. 43,087 (August 13, 1993). The proposed changes to Commission rules 1.17 and 1.19 would permit two-way dealer markets by futures commission merchants in certain OTC options subject to CFTC jurisdiction for which there is a capital treatment. Such activity is currently prohibited. See also 58 Fed. Reg. 27,486 at 27,491 (May 10, 1993). In a concept release on broker-dealer participation in the derivatives products markets, in which several questions concerning market structure are raised, the SEC stated that:

The Commission recognizes that transactions in derivative products by firms, which are dually registered as broker-dealers and futures commission merchants ("FCMs"), may raise capital compliance issues that need to be addressed in coordination with the CFTC. In this connection, the CFTC has informed the Commission that it is reviewing the continuing appropriateness of its Rule 1.19, which precludes firms registered as FCMs from offering, underwriting or assuming financial responsibility for dealing in OTC commodity options, except for options

address OTC activity in affiliates of its regulated licensees. These activities are a part of the Commission's review of the structure of the regulated exchange market in light of the evolving OTC marketplace.

The securities regulators also have monitored the evolution of derivative products, and in particular OTC derivative products, and have attempted to address these products within a comprehensive framework for the regulation of securities and securities intermediaries which has always accommodated OTC activity. The SEC has: (1) participated with the CFTC and other financial agencies in studies concerning such products;²² (2) adopted risk assessment rules requiring the reporting of data on the off-balance sheet derivative transactions of major affiliates of registered broker-dealers that carry customer accounts;²³ (3) issued a concept release relative to its net capital rule that discusses various risks to broker-dealers from OTC derivatives transactions;²⁴ and (4) issued a concept release discussing the regulatory implications of certain changes in market structure.²⁵ Among other things, the SEC's concept release on capital posits two possible approaches to the existing capital requirements for broker-dealers that undertake derivative transactions either directly or through affiliates. One approach would moderate the regulatory approach to credit risk in the broker-dealer and, if adopted, would render the conduct of OTC activities in the broker-dealer less costly. Another would apply separate, more refined capital guidelines to so-called derivative product companies (generally triple A credit affiliates of a regulated broker-dealer).²⁶

The SEC also has initiated discussions as to whether to adopt a theoretical pricing model system for assessing capital charges ("haircuts") on broker-dealers' options positions for regulatory capital purposes.²⁷ Such a system ultimately would calculate capital charges on a portfolio basis. In connection

traded pursuant to the rules of a U.S. or foreign contract market.
Comment is requested on these and other additional issues in this area of concern to regulated firms.

58 Fed. Reg. at 27,491.

²² See, e.g., A Study of the Effects on the Economy of Trading in Futures and Options, Board of Governors of the Federal Reserve, CFTC and SEC Joint Study (December 1984); and Market Reform Act Reports for 1991, 1992 and 1993.

²³ 57 Fed. Reg. 32,159 (July 21, 1992).

²⁴ 58 Fed. Reg. 27,486 (May 10, 1993).

²⁵ 57 Fed. Reg. 32,587 (July 22, 1992).

²⁶ See Working Paper 6.

²⁷ A "haircut" is a deduction taken in a firm's capital computation in order to account for specific risks

with this review of market structures, and in contemplation of possible modifications to its regulatory regime, the SEC, in the same release, has spearheaded a more comprehensive discussion of the various risks of OTC derivative transactions. These include: market risk or position risk; pricing risk; credit or default risk, including concentration risk; systemic risk; liquidity risk; operating risk; and legal risk.

The several domestic banking supervisors²⁸ separately have discussed the risks posed by derivative products with respect to banks acting both as dealer and end-user counterparties. Although finding the types of risk not unique to derivative products--in that they reflect the economic characteristics of the underlying instruments--the bank regulators espouse concern that the risks of such investments may be more complicated to assess and that bank management may not have sufficient expertise to evaluate dynamic, complex portfolios. Banking supervisors also have stressed strengthening internal controls and valuation methodologies for appropriate risk management of such positions. They appear to believe that, at least for banking institutions, the traditional concepts of safety and soundness and the direct examination approach to supervision can be adapted to address any implications of risks related to OTC derivatives. The questions these supervisors have raised focus on: (1) how to implement changes within the existing regulatory context including risk-based capital and reporting requirements; (2) whether there is adequate information available under existing authorities to assess creditworthiness of end-user counterparties and the size and scope of the OTC derivatives marketplace, and (3) whether there are threats to the market from institutions that fall outside the current regulatory framework.

Like the SEC and the CFTC, bank regulators also have provided practitioners with exposure drafts of potential approaches to derivative risk which raise questions concerning the appropriate capital treatment

and uncertainty and is enumerated in regulatory capital rules. It is, in effect, a regulatory reserve. Haircuts are required to reflect the market risks of positions held, such as an obligation to deliver a foreign currency under a forward contract (a 6% charge is required for the G-7 currencies), or to reduce the book carrying value of an asset for uncertainty. The intended regulatory result is that a firm's capital, after the deduction of all required haircuts, will be the amount of liquid capital a firm has, after a reserve has been set aside for the aforementioned market contingencies.

²⁸ These include: Office of Comptroller of the Currency, Department of the Treasury (national banks); Board of Governors of the Federal Reserve System (state member banks, bank holding companies); Federal Deposit Insurance Corporation (state non-member insured banks); and the various state banking authorities (state chartered banks).

for various types of positions. Additionally, disclosure, valuation and pricing methodologies, whether the use of margin to measure capital charges for market risk is appropriate, permitted offsets, appropriate netting and documentation of transactions, and other matters which may implicate bank use of both on-exchange and off-exchange derivative products have been important aspects of bank regulators' inquiries concerning OTC derivatives.²⁹

Each domestic regulator is using existing tools to determine how best to address its traditional responsibilities and regulatees. Nonetheless, there are common concerns about: (1) the interface among the various types of on-exchange and off-exchange markets and transactions; (2) these markets' and transactions' potential effects on each other and on the transfer of risk within the financial system; and (3) whether the mechanisms for regulatory coordination and information-sharing could be improved.³⁰ There are also concerns among international banking regulators as to whether market developments may bring to the marketplace new intermediaries or types of counterparties that perform functions which are similar to functions performed by regulated entities but which elude regulation because they are not financial institutions. Outside the United States, similar inquiries are in progress in several jurisdictions and among international regulators.³¹

Below follows a discussion of existing regulation for derivative products, an overview of the types of risks raised by OTC derivatives relative to existing regulatory systems, and a suggested approach for future action.

²⁹ Risk-Based Capital Guidelines: Collateralized Transactions, 58 Fed Reg 43,822 (August 18, 1993) (comment period ended September 17, 1993); Risk-Based Capital Standards: Interest Rate Risk, 58 Fed Reg 48,206 (September 14, 1993) (comment period ends October 29, 1993); Netting Eligibility for Financial Institutions, 58 Fed Reg 29,147 (May 19, 1993) (comment period ended August 20, 1993); Publication of Documents on Market Risk and Capital by the Basle Committee on Banking Supervision, 79 Fed. Res. Bull. at 614 (June 1993) (public comment period extends through year-end 1993); Promisel Report, supra.

³⁰ In this connection, following the recommendations in the Promisel Report, supra, the Group of Ten Countries set up a Working Group of the Bank for International Settlements on the measurement of market size and risks in derivative markets.

³¹ Australia, Ontario, U.K., International Organization of Securities Commissions. (See also Working Paper 3).

Common Elements of Regulated Exchange Markets and Intermediaries That Address Derivative Risks

Certain protections are basic to both the futures and securities regulatory and self-regulatory regimes for exchange marketplaces. These relate to: the financial integrity of the market; customer protection; the efficiency of the market; and the financial integrity and fairness of business conduct of intermediaries acting as brokers for transactions in or, with respect to securities, as dealers in, regulated products.

Financial Integrity of the Market

The financial integrity of transactions on CFTC- and SEC-regulated exchange markets is supported by requirements applicable both to intermediaries acting for customers in regulated transactions and to the exchanges on which such transactions are executed. FCM and broker-dealer minimum capital requirements, financial reporting requirements, including early warning procedures for declines in firm capital and other specified events, and customer funds protections help to assure that customer funds and property deposited with a broker, or accruing as a result of transactions effected by a broker, are secure. Further, the integrity of transactions effected on the exchange markets is supported by clearing organizations which clear, settle and guarantee performance of obligations to their clearing members. Futures clearing organizations and registered securities clearing agencies are subject to the oversight of the relevant agency, including review of clearing organization rules. Clearing organizations impose their own capital requirements for clearing members, generally at significantly higher levels than minimum capital requirements established by the CFTC and the SEC for FCMs and broker-dealers.

Margin requirements are a key financial protection under both regulatory regimes for derivatives. The futures exchanges, in addition to requiring standing (original) margin for each futures contract, also make daily (and on some exchanges intra-day) mark-to-market settlements that distribute all profits and losses accrued each day. Credit risk is thus eliminated from the clearing system on at least a daily basis. For exchange-traded options, the Options Clearing Corporation conducts a daily settlement with its

members. Under both regulatory frameworks, the exchanges are charged with primary responsibility for assuring compliance by their members with capital requirements and other financial requirements.

Customer Protection

Open, Competitive and Fair Transaction Execution. Both futures and securities regulatory structures include requirements designed to assure customer protection, competitiveness and transparency of exchange markets. Requirements relating to the manner in which regulated transactions are executed require open and competitive execution of trades, prohibit manipulation and fraud, and proscribe certain trading abuses. The CEA and CFTC rules require execution of futures transactions by open outcry or other methods which are open and competitive, and prohibit wash sales, fictitious trades and other trading activities which may distort prices, disadvantage public customers, or create misleading appearances of trading activity. Securities brokers have an obligation to obtain best execution of orders entrusted to them, and members of national securities exchanges are generally prohibited from effecting a transaction unless priority, parity and precedence in execution is given to orders for the accounts of non-exchange members. Both the futures and securities regulatory frameworks impose certain limitations on the use of material non-public information relating to transactions in regulated products consistent with their statutory authority.

Transparency. Both the CFTC and SEC require markets subject to their regulation to disseminate publicly information on price and volume of transactions and to maintain records of transactions to permit reconstruction of trading and detect and sanction abuses. CFTC rules require that exchange prices be recorded at least every 10 seconds and that exchanges disseminate volume and last sale price information daily. SEC rules require the exchanges (and NASD) to make price and volume information available pursuant to SEC-approved plans for transaction reporting systems, such as the plan that resulted in the "consolidated tape" that disseminates price and volume information with respect to listed securities.

Market and Trade Practice Surveillance. Under CFTC and SEC requirements, regulated exchanges maintain day-to-day market and trade practice surveillance programs to detect potential trading

abuses and manipulative activity. Under both regulatory frameworks, the exchanges, as self-regulatory organizations ("SROs"), monitor trading patterns for possible trade practice violations and market manipulations. CFTC and SEC staffs conduct regular reviews of SRO surveillance systems and investigatory, proficiency examination and disciplinary programs. In addition, the CFTC and SEC use their own surveillance capabilities to test SRO systems and to analyze specific transactions. Under both regulatory frameworks, audit trails for all transactions are required to facilitate detection and prosecution of trading abuses.

Futures exchanges are required to provide procedures such as arbitration for the resolution of customer grievances against exchange members and their employees. Securities SROs have likewise established arbitration procedures to handle investor grievances against broker-dealers.

Market Efficiency

Review of New Products. A futures contract may not be traded until the sponsoring exchange has been designated by the CFTC as a contract market for such trading. The contract market designation process includes a review of contract terms and conditions to determine whether trading in the proposed contract appears susceptible to manipulation and whether the contract will serve an "economic purpose," that is, whether the contract is likely to be used for hedging or price basing purposes on more than an occasional basis.³² Although not expressly required by the CEA, all exchange-traded futures and options contracts are standardized and fungible.

The federal securities laws do not contain an express "economic purpose" test for new products, but the SEC must condition approval of any new product proposed for exchange trading upon a finding that the introduction of the product is in the public interest. The SEC reviews exchange rules establishing standards for listing of securities for trading.

Prohibition of Certain Trade Practices. As discussed above, futures and securities regulatory

³² Section 5(7) of the CEA, 7 U.S.C. § 7(7), requires that a board of trade seeking contract market designation demonstrate that transactions in the proposed contract "will not be contrary to the public interest." This public interest standard has been determined to include the economic purpose test referred to above.

requirements proscribe fraud, manipulation, and other types of trading activity, such as fictitious transactions or wash sales, that may create false or misleading appearances of trading activity or distort the price of a futures contract or security.

Market Surveillance and Disruption Programs Futures and securities exchanges are subject to federal regulatory as well as self-regulatory mechanisms designed to protect the marketplace in emergency situations. Under the CEA and CFTC rules, futures exchanges are required to maintain market surveillance programs to detect possible congestion or other market situations conducive to price distortion. Exchanges must take remedial actions to address such situations, including emergency actions in appropriate cases. The CFTC also conducts direct surveillance of the markets using reports on the positions of large traders which FCMs are required to file with the agency. To prevent market distortions and protect the delivery process for futures contracts, the Commission has established, or approved exchange-established, speculative position limits or position accountability limits. The CFTC has statutory authority to take emergency action when it finds that there is a threatened or actual manipulation or corner or "other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand."³³

The CFTC and the SEC have approved coordinated circuit breaker rules pursuant to which trading in stock index futures and options, securities options, and securities, will halt when the Dow Jones Industrial Average declines by certain pre-set amounts. The SEC has issued proposed rules to implement its own large trader reporting system.³⁴ The 1934 Act provides that the SEC may take action in an emergency to maintain or restore fair and orderly securities market (other than markets in "exempted securities").

Regulation of Intermediaries

The CFTC and SEC regulatory frameworks address in largely parallel fashion the activities of intermediaries engaging in transactions in regulated products.

³³ CEA § 8a(9); 7 U.S.C. § 12a(9).

³⁴ 56 Fed. Reg. 42,550 (August 14, 1991).

Financial Safety Protections. Both the CFTC and SEC regulatory structures recognize the critical role of intermediaries in protecting the financial integrity of transactions for which they are responsible. As noted above, FCMs and securities broker-dealers are subject to minimum capital requirements and requirements for the protection of customer funds and property.³⁵ The Commission's capital rule defers to the SEC's haircuts on proprietary positions in securities, to reflect the market risk in such positions, and to the SEC's minimum capital requirement and calculation methodology if securities brokerage is a given firm's dominant line of business.

Customer funds protections are particularly strict with respect to futures accounts for which, unlike securities, no government-sponsored insurance program exists. The CEA and CFTC rules require that 100% of funds owed to customers, based on their account equities, be segregated from firm funds and treated at all times as belonging to such customers. FCMs are required to perform a daily calculation of funds required to be segregated, based upon funds received from customers and daily marking-to-market of customer positions. FCMs and broker-dealers are subject to annual audits. They are also required: to report any material inadequacies in internal controls; to maintain extensive records; and to provide written confirmations to customers of transactions effected for their accounts. FCMs are required to diligently supervise the handling of customer accounts. Broker-dealers are likewise subject to supervisory obligations with respect to their employees.

Broker-dealers are required to have possession or control of all fully paid and excess margin securities of customers. The customer securities that are not within a broker-dealer's physical possession must be at one of seven specified locations. Broker-dealers are also required to make a periodic computation (in accordance with a specified formula) to determine the amount of funds they hold which are either customer funds or funds obtained from the use of customer securities ("credits"). From that amount, a broker-dealer subtracts the amount of funds which it is owed by customers, or by other broker-dealers, relating to customer transactions ("debits"). If the credits exceed the debits, a broker-dealer must deposit the excess in a Special Reserve Bank Account. If the debits exceed the credits, no deposit is necessary.

³⁵ 17 C.F.R. §§ 1.17, 1.20-1.30 (1993); 17 C.F.R. § 240.15c3-1 - 15c3-3 (1993).

FCMs and broker-dealers are subject to statutory bankruptcy provisions which are designed to protect customers and to reduce the likelihood of ripple or domino effects from a firm bankruptcy.³⁶ These provisions permit clearing organizations to liquidate positions and to make use of margin collateral, notwithstanding a bankruptcy filing. They also prevent trustees from "cherry picking" contracts by affirming gaining contracts and rejecting losing ones, and affirm the efficacy of multilateral netting effected through a clearing organization's substitution as the obligor on each exchange contract. Futures customers hold priority claims in bankruptcy, subject only to claims for costs of administering the bankrupt estate. Securities customer accounts carried by Securities Investor Protection Corporation member broker-dealers are insured up to \$500,000 for claims for cash and securities (cash coverage is limited to \$100,000).

Fitness Screening. The futures and securities regulatory frameworks require the registration of firms acting as brokers for customers and of their salespersons. The registration process includes screening of both firm principals and individual salespersons. The goal is to ban persons who have specified types of criminal or disciplinary histories from sales and intermediation functions. The securities laws require the registration of securities dealers--that is, persons engaged in the business of buying and selling securities for their own accounts--as well as brokers. As of April 1993, floor traders who engage exclusively in transactions for their own accounts on futures exchange markets are required to register as such.

Disclosure and Sales Practice Requirements Under both regulatory frameworks, solicitation activities and other sales practices are subject to statutory anti-fraud prohibitions and SRO rules and oversight. FCMs are required to provide CFTC-specified, generic risk disclosure documents to futures customers before opening accounts. Broker-dealers are required to furnish customers with a copy of the Options Disclosure Document prepared by the Options Clearing Corporation before approving a customer's account for trading standardized options or accepting a customer's order to purchase or sell a standardized option contract. The NASD's trading and sales practice rules, which apply to NASD member broker-

³⁶ See generally Working Paper 4 with respect to bankruptcy provisions applicable to FCMs and case studies of certain FCM failures.

dealers, prohibit member firms from recommending any options transaction to a customer unless they have reasonable grounds to believe that the recommended transaction is not unsuitable for the customer.

Non-Public OTC Transactions

Transactions in OTC derivative products, to the extent that they are potentially subject to jurisdiction under the federal securities laws or the CEA, generally are effected under exemptions from the general regulatory framework otherwise applicable to exchange markets or public securities offerings. These OTC derivative transactions generally occur in private transactions entered into directly by the counterparties, often with a dealer acting as market-maker counterparty, and are not secondarily traded. To the extent such transactions are subject to CFTC or SEC requirements, they generally are limited to participants who qualify as: (1) "accredited investors" or persons who are options-qualified under securities SRO criteria;³⁷(2) "eligible participants" or "appropriate persons," by virtue of their commercial or institutional status or financial resources, as defined by CFTC swaps exemptive rules; or (3) as commercials under the CFTC's trade options exemption.

CFTC Provisions for Off-Exchange Transactions

As noted above, the futures regulatory framework was designed to assure that all futures transactions would take place on regulated exchange markets through regulated intermediaries registered as FCMs and subject to minimum capital and other requirements. All other forms of futures transactions are generally prohibited, with the exception of certain types of commercial option transactions. Thus, the futures regulatory framework generally does not contemplate issuer- or dealer-initiated transactions in futures or commodity option products and generally renders unlawful futures and commodity option products that are effected other than on CFTC-designated exchanges.³⁸

³⁷ These criteria comport with recommendations made by the SEC in connection with its study of the securities options markets in 1978.

³⁸ CFTC rules recognize a limited category of "dealer options," confined to offerors who were in the business of granting options on a physical commodity and in the business of buying, selling, producing or otherwise using the commodity on which such options are offered as of May 1, 1978, and who comply with the requirements of CFTC rules. The CEA permits the Commission to establish a somewhat broader framework for dealer options but the Commission has not yet done so. At the present time, no dealer options are being offered. The CEA also recognizes instruments known as "leverage contracts," which are long-term (ten years or longer) contracts involving metals and foreign currencies offered and sold on an off-

The CFTC's regulatory provisions applicable to OTC derivatives have developed as a series of exceptions to the exchange-trading requirement. These exceptions generally have been predicated on the rationale that the exempted transactions are: (1) unsuitable for exchange trading; and (2) entered into by parties who are engaged in a line of business involving the commodity that is the subject of the transaction, or who satisfy financial criteria designed to assure their competence to engage in such transactions without the full complement of regulatory protections. Generally, these exceptions from the exchange-trading requirement have also exempted the affected transactions from most other regulatory provisions. The CFTC has not created for such transactions an alternate regulatory structure tailored to the OTC market.³⁹ Thus, the CFTC's long-standing trade options exemption and its more recently adopted swaps,⁴⁰ and energy contract exemptions restrict participation in exempted transactions to entities and persons who satisfy commerciality, institutional and/or asset-based standards. The exemptions extend not only to the exchange-trading requirement but also to virtually all other regulatory requirements. Such exemptions were granted pursuant to legislation requiring the Commission to make a determination that the exemption was in the public interest and would not adversely affect the integrity of exchange markets. The swaps and energy contract exemptions also contain requirements relating to the structure and operation of the transactions that are intended to further distinguish them from exchange-traded contracts.

OTC derivative products contemplated by the CFTC regulatory framework are discussed below.

Statutory Exclusion for Forward Contracts One type of OTC derivative product, the forward contract, is expressly excluded from CFTC jurisdiction and thus is essentially unregulated.⁴¹ Forward contracts are commercial, merchandising transactions in physical commodities in which delivery of the commodity is contemplated and routinely occurs but is deferred for commercial purposes. Forward contracts are privately negotiated, principal-to-principal transactions between commercial parties whose

exchange basis by leverage transaction merchants acting as principals to customers who make margin payments and are assessed carrying charges. At the present time, no leverage contracts are being offered.

³⁹ But see, note 38, *supra*.

⁴⁰ See 17 C.F.R. §35.1(b)(1) (1993), defining "swap agreement."

⁴¹ See CEA Section 1a(11), 7 U.S.C. §1a(11) and note 14, *supra*.

business activities involve the commodity underlying the transaction. The forward contract exclusion has been a part of the federal statutory framework since the inception of futures regulation and was intended to assure that the regulatory structure would not interfere with transactions in the commercial merchandising chain. The policies reflected in the forward contract exclusion have been relied upon, in part, for the CFTC's exemptions for swaps and energy contracts.

Trade Options. Trade options are exempted by CFTC rules from the general prohibition against off-exchange futures and commodity options transactions. They are off-exchange commodity options offered and sold to commercial counterparties whose business involves the commodity (or by-products thereof) that is the subject of the transaction and who enter into the transactions for purposes related to that business. Rule 32.4(a) permits the sale of off-exchange commodity options in circumstances in which the offeror "has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction" and that such commercial party is offered or enters into the transaction "solely for purposes related to its business as such."⁴² Trade option transactions are subject to prohibitions against fraud, certain types of representations, and unreasonable failures to secure prompt execution of commodity option orders by persons receiving such orders. Currently, trade options on agricultural commodities are prohibited.

Swaps. Pursuant to exemptive authority granted under the FTPA and now set forth in Section 4(c) of the CEA, the CFTC recently adopted exemptive rules which provide a safe harbor from most CFTC regulatory requirements for swap transactions meeting specified criteria.⁴³ The exemption is limited to swap agreements entered into by "eligible swap participants," which include various categories of institutional and commercial entities and natural persons with substantial assets. Eligible swap participants include, for example: banks; investment companies; corporations or other entities which have total assets exceeding \$10,000,000, or net worth exceeding \$1,000,000 and are entering into the swap

⁴² 17 C.F.R. §32.4(a)(1993).

⁴³ 17 C.F.R. Part 35 (1993).

transaction in connection with the conduct of their business; employee benefit plans subject to ERISA with total assets exceeding \$5,000,000; broker-dealers; futures commission merchants; and natural persons with total assets exceeding \$10,000,000.

In addition to restricting the categories of participants eligible to participate in exempt transactions, the CFTC's swaps exemptive rules impose restrictions upon the design and execution of the transactions that distinguish them from exchange traded futures contracts. To qualify for exemption: the swap may not be part of a fungible class of agreements that are standardized as to their material economic terms; the creditworthiness of any party having an actual or potential obligation under the swap agreement must be a material consideration in entering into or determining the terms of the swap agreement; and the swap agreement may not be entered into or traded on a multilateral transaction execution facility (a physical or electronic transaction execution facility in which participants can simultaneously effect transactions and bind both parties).

The CFTC swaps exemption does not exempt swaps from all statutory anti-fraud and manipulation prohibitions.⁴⁴ However, in all other respects the exemption allows swaps transactions to occur free of the regulatory framework applicable to futures exchanges and intermediaries. No prescriptive, affirmative requirements as to the conduct of the transactions, other than the participant, design and execution criteria of the exemptive rules apply to qualifying swaps.⁴⁵

Energy Contracts. By order issued April 13, 1993,⁴⁶ the CFTC exempted certain contracts for the

⁴⁴ The swaps exemption is also subject to CEA Section 2(a)(1)(B), 7 U.S.C. § 2a which relates to, among other things, the allocation of regulatory responsibility for stock index futures contracts and options between the CFTC and the SEC and imposes certain interagency requirements with respect to approval of stock index futures trading.

⁴⁵ Although the CFTC's swaps exemptive provision preserves the applicability of statutory anti-fraud and manipulation prohibitions, these prohibitions are limited to specified types of conduct involving futures contracts or the cash market. There is no statutory or regulatory anti-fraud provision expressly designed to cover swaps. For example, CEA § 4b, the general antifraud provision applicable to futures contracts, prohibits, among other things, any person from cheating, defrauding or attempting to cheat or defraud any person "in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery . . . for or on behalf of any other person." Liability under this provision thus would arise from a swap transaction only to the extent that a futures contract under the CEA were shown to be involved.

⁴⁶ 58 Fed. Reg. 21,286 (April 20, 1993).

deferred purchase or sale of specified energy products from regulation under the CEA. The order applies to contracts for the deferred purchase or sale of crude oil, condensates, natural gas, natural gas liquids, or their derivatives that are used primarily as an energy source. The contracts must be entered into between commercial participants meeting specified requirements. These requirements relate to, among other things: the capacity to make or take delivery; and regulated status, minimum net worth or total assets, which evidence the commercial status of the parties and distinguish the exempted transactions from those required to be effected on approved exchanges. Under the order, qualifying contracts are exempted from all provisions of the CEA except Section 2(a)(1)(B), the so-called "jurisdictional accord" between the CFTC and SEC, and the provisions prohibiting price manipulation.

Foreign Currency Transactions. Foreign currency transactions are subject to varying types of regulation under the CEA, depending on the context in which they occur and the nature of the counterparties. Spot (or "cash") foreign currency transactions and forward contracts on foreign currencies are excluded from regulation under the CEA, as are all other spot and forward transactions. Foreign currency futures and option transactions are subject to the CEA exchange-trading requirement and all other applicable requirements except to the extent that foreign currency options may be traded on national securities exchanges subject to SEC regulation⁴⁷ or are exempted by CFTC rule. Two CFTC regulatory exemptions are potentially available with respect to foreign currency options: the trade option exemption, which is limited to options offered to commercial users; and the swaps exemption, which includes within the definition of swap agreement for purposes of the rule an agreement which is a "currency option."⁴⁸

Discussion of the regulatory treatment of foreign currency transactions is further complicated by the so-called "Treasury Amendment,"⁴⁹ a CEA provision which states that the CEA shall not be deemed to apply to, among other things, "transactions in foreign currency, . . . unless they involve a sale for future

⁴⁷ Foreign currency options traded on CFTC-regulated exchanges are subject to the CFTC's regulatory framework to the same extent as all other futures and exchange-traded commodity options; foreign currency options traded on national securities exchanges are regulated by the SEC. CEA § 4c(f), 7 U.S.C. § 6c(f); 15 U.S.C. § 78i(g).

⁴⁸ 17 C.F.R. § 32.4(a)(1993); 17 C.F.R. § 35.1(b)(1)(i) (1993).

⁴⁹ CEA § 2(a)(1)(A)(ii), 7 U.S.C. § 2(ii).

delivery conducted on a board of trade." The scope of this provision has been subject to considerable debate and litigation. Its legislative history suggests that the statutory provision was intended to preclude CEA regulation of the interbank market, which was described as a market subject to bank regulatory oversight, in which transactions generally occurred between banks and "other sophisticated institutional participants."⁵⁰ This "market" was believed to be "more properly supervised by the bank regulatory agencies."⁵¹ The CFTC has interpreted the Treasury Amendment to be inapplicable to transactions involving members of the general public, but not all courts have agreed with that view.⁵²

SEC Regulation of OTC Securities Derivatives

Application of the SEC framework to off-exchange transactions does not occur through the mechanism of product-specific regulatory exemptions such as exist under the futures regulatory scheme. The term "security" is broadly defined in both the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").⁵³ The SEC therefore considers any investment contract a security subject only to the provisions of the CEA which confer exclusive jurisdiction with respect to certain rights or interests.⁵⁴ The regulatory structure for primary securities offerings, the 1933 Act, would apply to the primary offering of securities derivative products. Absent an exemption, an issuer of such a security must register it with the SEC.⁵⁵ However, issuers of such products in privately negotiated, principal-to-principal transactions in the OTC market may be able to claim exemptions under Section 4(2) of the 1933 Act⁵⁶ from both the registration and prospectus requirements of Section 5.⁵⁷ The Section 4(2) exemption would not

⁵⁰ S. Rep. No. 93-1131, 93d Cong., 2d Sess. 23 (1974).

⁵¹ Id.

⁵² See the discussion of Salomon Forex, Inc. v. Tauber, No. 92-1406 (4th Cir. October 18, 1993), and CFTC v. Standard Forex, Inc., C.V. 93-0088 (E.D.N.Y. August 9, 1993) in Chapter V.

⁵³ Section §2(1) of the 1933 Act, 15 U.S.C. § 77b(1); Section 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10).

⁵⁴ CEA § 2(a)(1)(A)(i), 7 U.S.C. § 2(i).

⁵⁵ Underwriters and broker-dealers participating in the distribution of securities by the issuer are similarly governed by the prohibitions of Section 5 of the Securities Act of 1933.

⁵⁶ Section 4(2) exempts from the requirements of Section 5 transactions by an issuer not involving any public offering. The Section 4(2) exemption applies to offerings to a limited number of investors with financial sophistication and access to material information concerning the issuer. The SEC adopted Rule 506 (17 C.F.R. § 230.506), as part of Regulation D to provide a safe harbor for use of the Section 4(2) exemption. Rule 144A, adopted by the SEC in 1990, provides a safe harbor for resales of privately placed securities among "qualified institutional buyers."

affect liability under the provisions of Section 12(2) (civil liability for the sale of securities by misleading statements or omissions) or Section 17 (anti-fraud). Generally, to the extent that the OTC derivative product is offered and sold between private parties without the assistance or intermediation of a broker-dealer or registered investment adviser, these anti-fraud provisions, together with the anti-fraud provisions of Rule 10b-5 under the 1934 Act, would appear to be the primary applicable protections of the SEC's regulatory framework.

If, however, a registered broker-dealer "issues" the product, such as by writing an option, or intermediates between the parties, the SEC's regulatory framework as it applies to broker-dealers would be relevant. Registered broker-dealers effecting transactions in OTC options are subject to the NASD's Rules of Fair Practice, which include customer suitability requirements, and SRO rules relating to position limits.⁵⁸ Also, broker-dealers that are members of options exchanges are subject to certain minimum margin requirements with respect to OTC option transactions.⁵⁹ Moreover, the OTC transaction will have an impact on the broker-dealer's net capital computations. Finally, Sections 15(c)(1) and 15(c)(2) of the 1934 Act make it unlawful for broker-dealers to effect transactions in the OTC market through fraudulent, manipulative, or deceptive acts or practices.

Banking Regulation

The regulatory structure for domestic banks and bank holding companies is shared among several federal regulators and the states and is quite complex. Bank supervisors address bank activities in

⁵⁷ Alternatively, an exemption relating to the nature of the security may be available. For example, Section 3(a)(2) of the 1933 Act, 17 U.S.C. 77c(a)(2), provides for the exemption of, among other securities, bank-issued securities.

⁵⁸ Appendix E of the Rules of Fair Practice sets forth rules regarding options transactions. These rules apply

. . . to the extent appropriate unless otherwise stated herein, to the conduct of accounts, the execution of transactions, and the handling of orders in "conventional options". . . .

Appendix E, § 1(a)(3).

⁵⁹ See Becker, Gira and Burns, Derivative Markets Developments, September 15, 1992 (prepared for the Fifteenth Annual Commodities Law Institute and the First Financial Services Law Institute) at 23, citing Appendix E of the NASD's Rules of Fair Practice and New York Stock Exchange Rule 431.

derivatives by, among other things, limiting the types of permissible transactions, imposing internal control and risk management duties, requiring that derivative activities be reflected in minimum capital requirements and leverage ratios, and mandating reports and recordkeeping concerning such activities. These regulatory requirements may apply to banks whether they are performing intermediary functions for customers or engaging in proprietary trading activity. In either case, the rationale for applying the regulatory framework is that banks act as custodians, credit intermediaries and sources of liquidity to the payment system and their financial soundness must therefore be safeguarded. Federal banking regulation differs from the federal futures and securities regulatory frameworks in that it consists of oversight of entities, rather than of products or markets, and relies on direct examination and supervisory activities as opposed to oversight of self-regulation. Banking regulation therefore does not contemplate direct oversight of a market. Even in the so-called "interbank market," regulatory oversight is limited to participating entities and does not entail reporting of prices or transactions.

End-User Regulation

OTC derivatives participants apparently include many entities, in addition to banks, that are subject to other regulatory frameworks. Pension plans and employee welfare benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) are subject to a general requirement that transactions involving plan assets be undertaken with prudence and not be undertaken with interested parties. They are also subject to the Department of Labor's reporting, recordkeeping and disclosure requirements established under ERISA.

The Investment Company Act of 1940 (ICA) is a comprehensive regulatory framework which establishes structural, governance, investment, disclosure, reporting and recordkeeping requirements for entities required to register as investment companies. The ICA imposes various types of investment restrictions, including a prohibition against issuance by open-end investment companies of senior securities which has been construed to include certain types of derivative transactions that involve "leveraging" of the assets of the investment company unless conducted in accordance with certain asset-coverage requirements.

Restrictions on the sale of OTC products, e.g., as provided in the CFTC's swaps and energy contract exemptions, except to "eligible" or "appropriate" persons, also can be described as end-user regulation.

Summary of Regulatory Status of OTC Derivatives

As the OTC derivatives marketplace does not consist of a distinct category of products having common characteristics, there is no single regulatory treatment applicable to all such products. Outside regulated markets, in which derivative transactions are generally standardized, products may be endlessly customized and reconfigured. New products may combine elements of futures, options, securities or other interests and thus may represent amalgams of multiple products, regulated and unregulated, which may not fall neatly within the confines of any existing regulatory definitions. At the same time that OTC derivative transactions have proliferated, documentation, such as standard master agreements, has developed for certain types of such contracts⁶⁰ which provides some conformity of terms and conditions to facilitate netting and risk management activities.

Notwithstanding the diversity of OTC derivatives, however, certain general observations can be made as to the manner in which such transactions are conducted and the extent to which regulatory requirements affect their design and operation. As noted above, within the current structure, OTC derivative transactions are addressed primarily as "transactions" or as "exposures" of intermediaries or dealers regulated under existing futures, securities or banking provisions. For example, existing capital requirements for regulated intermediaries take account of such transactions and regulatory risk assessment or consolidation regimes attempt to assess and protect the regulated entity from derivative exposures. Existing regimes, however, also allow such products to be privately offered to commercial parties or other accredited persons under long-standing (in the case of securities) and new (in the case of futures) exemptions from the application of certain regulatory protections otherwise afforded to investors. Also, although many derivative transactions are undertaken in financial institutions which are subject to

⁶⁰ See, e.g., International Swap Dealers Association, Master Agreement, Multicurrency-Cross Border (1992).

regulation, some may occur among end-users or through the facilities of intermediaries designed to avoid implicating such requirements. Consequently, to a considerable extent, the conduct of OTC derivatives transactions may be guided by private contractual arrangements with respect to certain matters which in other contexts (i.e., exchange markets) historically have been governed by regulatory or self-regulatory requirements.

Further, the regulatory systems in place may not fully encompass all types of dealing activities in OTC transactions. Concern has been expressed regarding the potential competitive effects of differential regulatory requirements for performance of similar functions. Moreover, as derivative transactions may readily cross borders, the regulatory landscape for such transactions should be viewed from a global perspective. The differences in their treatment from jurisdiction to jurisdiction, particularly from a legal perspective, may be profound.

CHAPTER III

POTENTIAL RISKS ARISING FROM OTC DERIVATIVES TRANSACTIONS

The Congressional directive for this study requested that the Commission determine, among other things, the "potential risks presented by the markets for swaps and other off-exchange derivative financial products."⁶¹ Similar interest in the possible risks of over-the-counter (OTC) derivatives has been voiced by a variety of regulators, domestic and international, and in the private sector.⁶²

This chapter summarizes a number of potential risks from OTC derivatives transactions that have been identified by regulators and other interested parties. At the outset, it is important to note that many of the risks discussed in connection with OTC derivative products are not unique to those products but are common to other financial products. Further, to the extent that the risks of OTC derivative transactions are associated with the absence of exchange trading structures, clearing organizations, standardization of products and other aspects of such transactions that distinguish them from more regulated transactions, the absence of these restrictions also is associated with benefits. In the relative absence of regulatory and self-regulatory standards that restrict the structure and conduct of transactions, participants are free to design instruments that are tailored on an individualized basis. As such, OTC products can redistribute risks precisely and efficiently. This latitude is viewed by market participants as one of the key benefits of the OTC derivatives marketplace.⁶³

⁶¹Conference Report on FTPA of 1992, H.R. Rep. 978, 102nd Cong., 2d Sess. 83 (1992).

⁶² Net Capital Rule: Concept Release, 58 Fed. Reg. 27,486 (May 10, 1993) (SEC); Bank of England, Derivatives: Report of an Internal Working Group (April 1993) ("Bank of England"); Bank for International Settlements, Recent Developments in International Interbank Relations (October 1992) ("Promisel Report"); Australian Securities Commission, Draft Report on Over-the-Counter Derivatives Markets (July 1993) ; Derivatives: Practices and Principles, Global Derivatives Study Group, Group of Thirty (July 1993) ("Group of Thirty Report"); Speech of Mary L. Schapiro, Commissioner, SEC, The Growth of the Synthetic Derivative Market: Risks and Benefits, National Option & Futures Society, November 13, 1991 ("Schapiro"); Remarks by William J. McDonough, President, Federal Reserve Bank of New York, Group of Thirty Seminar on Derivative Financial Instruments, September 27, 1993 ("McDonough"); Remarks of Susan M. Phillips, Member, Board of Governor's, the Federal Reserve System, "OTC Derivatives: A Regulators Perspective," Conference on Risk Management, Owen Graduate School of Management, Vanderbilt University, April 15, 1993 ("Phillips"); Remarks by F. Gerald Corrigan, President, Federal Reserve Bank of New York, 64th Annual Mid-Winter Meeting of the New York State Bankers Association, January 30, 1992.

⁶³ See, e.g., Schapiro, *supra*.

The potential risks of OTC derivatives transactions also need not necessarily be equated with the extent to which they are unregulated. Each of the regulatory safe harbor or exemptive approaches to the various types of OTC derivatives transactions, which were developed incrementally by Congress and multiple regulatory authorities over decades, was founded upon a recognition that the transactions were of a commercial or non-public nature between parties otherwise subject to registration and able to protect themselves without the benefit of otherwise applicable regulatory safeguards. Concerns about the potential risks of OTC derivatives transactions do not necessarily call into question the appropriateness of these various regulatory treatments. Instead, the issues raised with respect to potential risks raise more difficult questions about the extent to which the wide array of OTC derivatives products, viewed on a generic, aggregate basis, may create risks for firms, other market sectors, or the financial system as a whole that warrant heightened regulatory scrutiny.

Discussions of potential OTC derivative risks have often endeavored to distinguish risks that originate from the activities of an individual firm from those that are "systemic" in nature. Systemic risk has been defined as the risk that a disruption, whether at a firm, a market segment, or across markets, will cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole.⁶⁴ In the context of this general definition, risks arising from the operations of individual firms may have systemic risk implications. Firm disruptions also may affect entities with significant obligations to public participants, such as financial institutions with custodial responsibilities to pension holders or banks to depositors. Consequently, the following discussion summarizes potential risks, including risks originating in specific firms and generally confined to such firms, as well as more generic concerns about OTC derivatives transactions and aggregate OTC derivatives activity, without characterizing any such risk as inherently systemic in nature.

Potential Risks Originating in Individual Firms

The widespread view that the risks arising from a particular firm's extensive activity in OTC derivatives, if improperly managed, could have systemic implications is a primary factor behind the current

⁶⁴ Promisel Report, *supra*.

move to further explore the nature and significance of these risks from a regulatory perspective. The failures of derivative market participants that have occurred to date have been successfully confined to the failing firm and have been absorbed by the marketplace, and indeed have given witness to the ability of regulators to cooperatively address given market situations with tools already on hand.⁶⁵ It is also the case, however, that such failures may not have been large enough to test the system, and occurred under relatively quiet market circumstances where general market liquidity was not compromised, and in which regulators had some capability to assist in the unwinding process.⁶⁶

Market Risk

Market risk is the risk of loss caused by changes in the market value of a position until it can be offset or liquidated. Market risks in positions held in inventory are addressed for regulatory capital purposes by haircuts in the value of those positions. These haircuts are intended to cover the potential loss in realized value if the position carried by a broker-dealer or FCM must be liquidated. For regulatory capital purposes, all securities and futures positions carried by a broker-dealer or FCM must be marked to market. Because market risk in a derivative relates to market risk in the underlying interest, the risk may be hedged or reduced by a cash position in the underlying interest. It is possible to measure the aggregate risk of complex positions of cash and derivatives on a portfolio basis, combining positions to develop a net risk measure. Because volatility changes can be abrupt, however, especially in leveraged positions, net risk can increase abruptly as well.

Exchange futures markets currently use margining systems that are portfolio-based, are adjusted if the risk to the market participant is offset by a cash position, and draw on simulation analysis and options pricing theory to measure the potential risk of one-day price moves to a specified level of probability. These margin methodologies are adjusted periodically to reflect changes in implied volatility. Since 1988, risk simulation analysis also has been a recommended part of the direct financial surveillance maintained by each regulated futures market. Aggregate information on regulated market exposures, including deficits

⁶⁵ See generally Working Paper 4.

⁶⁶ Remarks of Brian Quinn, Executive Director, Bank of England, before the Group of Thirty Seminar on Derivative Financial Instruments, September 27, 1993 at 6-7.

and excess margin, is available on-line for all futures markets and for Options Clearing Corporation index options. Unregulated cash exposures are available on special call or through exercise of the Commission's risk assessment inspection authority.

In the context of OTC derivatives transactions, market users are responsible on an individual basis for management of the market risks of transactions, and individual firm risk management procedures are the primary safeguard against the consequences of such risks for the firm and its counterparties. All dealers interviewed in the course of this study⁶⁷ described methods to price transactions, value portfolios, and evaluate and manage market risk. A number of dealers indicated that they had some type of risk management committee responsible for setting market risk limits. In some, but not all, cases this risk management committee was separate from the credit risk committee and the trading group. To evaluate market risk relative to assigned limits, scenario analyses are used to assess the risks associated with factors such as shifts in the yield curve, changes in the shape of the yield curve, and changes in the swap spread. Some dealers interviewed reported performing stress simulations to evaluate their portfolios under non-standard assumptions, for example, unexpectedly large price moves. All dealers interviewed stated that they mark their positions to market on a daily basis.⁶⁸ Most dealers interviewed stated that market risk limits and positions were reviewed daily.

End-users interviewed reported that they use computer software to price transactions and value positions. All indicated that they used a standard model to obtain a theoretical price and then shopped for quotes among dealers. With one exception, end-users reported marking their positions to market on a daily basis.⁶⁹

About half the end-users reported managing their market risk by putting on hedges at the time of the transaction or by matching transactions; the balance use a portfolio approach comparable to that of the dealers, including, for example, market risk committees and scenario analyses.

⁶⁷ See generally Working Paper 2.

⁶⁸ This accords with the Group of Thirty finding that all surveyed North American and U.K. dealers marked positions to market daily. Group of Thirty Report, supra, Appendix 1, Section 1 at 4.

⁶⁹ One reported weekly marking-to-market. See Working Paper 2.

Market risk is said to be of less concern than in the past due to the wide range of instruments available for hedging and position taking and greater expertise in using such products.⁷⁰ Nonetheless, some have questioned whether differences in proprietary risk pricing models can affect the level of firm protections and whether all market users are appropriately quantifying such risks on a portfolio basis.⁷¹ Others also are concerned that adequate understanding of the risks is not equally distributed among all users of the marketplace.⁷²

Credit Risk

Credit risk may be defined as the risk that a counterparty will default on an obligation. Although credit risk is present in every transaction between the trade date and settlement date, in most derivative products such risk changes over time based on market risk and in complicated dynamic strategies may change materially if not adjusted by taking other positions. Changes in market exposures based on volatility changes are also directly relevant to managing credit risk.

Existing exchange markets substantially reduce credit risk through collection of variation margin (the payment of losses on a daily or more frequent basis) and through interposition of a clearing organization as the guarantor of all transactions. By assuming the credit risk of individual transactions and mutualizing it among all clearing participants, clearing organizations transform the credit risk of individual counterparties into the far more remote risk of the failure of the clearing organization. Effectively, the creditworthiness of all participants is substituted for that of any single counterparty. Further, obligations of end-users of exchange-traded instruments, engaging in regulated transactions through regulated intermediaries, are effectively guaranteed by the clearing member which carries them. These end-users receive the benefit of creditworthiness protections applicable to the intermediary, such as minimum capital requirements, audit requirements, and customer funds protections.

Exchange regulatory and self-regulatory structures also address the risk that the default or failure

⁷⁰ See Promisel Report, supra.

⁷¹ See generally Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 Yale L. J. 1457, 1476-1481 (1993).

⁷² Group of Thirty Report, supra, Appendix 1, Section 4 at 66-67.

of one firm, whether through failure to manage risk or otherwise, will adversely affect others in the market. These safeguards include mechanisms, in addition to clearing house guarantees of positions, that localize the consequences of such failures, including procedures for the transfer of positions to financially stable firms or prompt liquidation of positions to minimize losses if such transfers cannot be effected. Further, end-users in the market are subject to reporting requirements, if they are large traders, and to speculative position limits or position accountability standards. These requirements facilitate third- party surveillance of concentration risk and impose some limitations upon the size of the outstanding market exposure of individual market users.

The financial integrity of OTC derivative transactions generally is unsupported by regulatory or self-regulatory protections such as margin requirements, clearing organizations, capital requirements, or financial compliance programs except to the extent that a derivatives counterparty is a regulated bank, broker-dealer or FCM. However, in the absence of such regulatory requirements, individual market participants construct and maintain their own mechanisms to reduce and manage credit risk. Market participants interviewed in the course of this study, including end-users as well as dealers, indicated that they would not engage in transactions with a counterparty without first approving that party's creditworthiness.⁷³ All participants interviewed reported using standard credit ratings obtained from credit rating agencies, such as Moody's, Standard and Poor's and/or Bank Watch; some dealers supplement these ratings with their own internal ratings.⁷⁴ Some credit risk-averse participants prefer doing business with a Triple-A-rated derivative products company affiliate of a regulated intermediary to dealing directly with such an intermediary on the theory that the affiliate company is isolated from other risks in the intermediary.⁷⁵

Interviewees reported that they established limits on both the amount and tenor (maturity) of contracts that would be permitted for each counterparty. In general, they indicated that such counterparty

⁷³ See generally Working Paper 2.

⁷⁴ Two dealers reported making on-site visits to evaluate potential counterparties' risk tracking systems. See Working Paper 2.

⁷⁵ See Working Paper 6.

limits were set by a department, such as a credit department, that was separate from the derivatives trading group.

All dealers interviewed reported using some type of collateral arrangement as a credit safeguard. A majority required only counterparties of lower quality credit to post collateral at the inception of the transaction; in other cases, collateral would be required to be posted based upon pre-specified triggers, such as credit rating declines. Some dealers included a daily mark-to-market provision in their agreements such that if the market value of a swap changed by more than a prespecified amount, the counterparty or the dealer would be required to post collateral if none had been required initially, or to post additional collateral.

About half of the end-users interviewed reported using collateralization for credit enhancement. All end-users interviewed who routinely use collateral included mark-to-market provisions that either required collateral or additional collateral if the swap market obligation changed by more than a prespecified amount. Both dealers and end-users reported including in their master agreements triggers, such as debt/equity ratios or net worth measures, which would result in early termination of the swap. Parties also indicated that they reduced credit exposures to less creditworthy counterparties by reducing the number and maturity of transactions.

Studies of OTC derivatives transactions have recommended various measures to reduce or control credit risk in OTC derivatives transactions, such as procedures relating to measuring, monitoring, and managing credit risk, and the use of master agreements for netting purposes. Such procedures include: internal control standards, such as measuring credit exposure on both a current (replacement cost) basis and a potential exposure basis using probability analysis; calculating aggregate derivative and other current credit exposure to a counterparty on a daily basis, at least for dealers; and maintenance of an independent credit risk management function.⁷⁶ The credit management function serves to approve credit exposure management standards, set and monitor the use of credit limits, review credits and concentration of credit risk, and review risk reduction arrangements. OTC derivatives studies also advocate updating the exposure

⁷⁶ Group of Thirty Report, supra, at 12-14.

of a firm's complex global position on a timely basis, and recommend that back-office operations be separated from risk-taking operations.⁷⁷ However, the extent to which risk control procedures of the type advocated as best practice by groups such as the Group of Thirty are actually standard practice remains unclear.

The extent to which credit risk is concentrated with one counterparty or type of counterparty is a significant factor in the evaluation and management of credit risk. Concentration of a portfolio with one counterparty or type of counterparty increases credit risk.⁷⁸ For this reason, regulatory capital requirements may include concentration charges to discourage assumption of extensive credit risk with any one counterparty.⁷⁹

The SEC Concept Release requests comment on how best to measure and secure against credit exposures, and the CFTC proposal to permit FCMs to grant certain over-the-counter options also requests comment on how best to measure such risks.⁸⁰ Netting arrangements also have been advocated as methods to reduce risks arising both from credit exposures and settlement obligations.⁸¹

Settlement Risk

Settlement risk can be described as the risk that a party which has fulfilled its obligations under an agreement or instrument by delivering funds or property will not receive within agreed settlement timeframes the funds or property owed by its counterparty. This risk may arise because a transaction involves an exchange of funds or property to be delivered at different times or in different time zones. Counterparties may seek to minimize settlement risks by making each set of payments as close in time as possible and by providing for transfers of net amounts only. Settlement risk can be divided into two types of risk: capital risk, the risk that a counterparty will fail during the settlement process; and market risk, the possibility that a transaction will have to be replaced at a different price because one or the other counterparty fails before

⁷⁷ Id. at 15-16.

⁷⁸ See generally Group of Thirty Report, supra, at 49.

⁷⁹ See proposed concentration charges discussed in the SEC's net capital rule concept release, 58 Fed. Reg. 27,486 at 27,494.

⁸⁰ 58 Fed. Reg. 27,486; 58 Fed. Reg. 43,087 (August 13, 1993).

⁸¹ Promisel Report, supra, at 35. Netting arrangements are discussed infra.

the agreed exchange of funds or property takes place.

Capital risk in the settlement process is considered to be avoidable only in the case of transfers that are simultaneously irrevocable and unconditional for all parties involved.⁸² The goal of a delivery versus payment (DVP) securities settlement system is designed to avoid this risk. In the futures markets, use of a single daily or intra-day net settlement procedure, by which the clearing organization either pays or collects a net sum to or from the clearing member, achieves the effect of DVP in a non-asset transfer context. In the absence of a DVP system, there are a variety of ways to reduce, redistribute or protect against capital and market risk through settlement systems. These include monitoring system membership; shortening settlement periods;⁸³ the use of netting arrangements; the introduction of a central counterparty; the use of collateral and margin; loss-sharing arrangements; and support from outside the market, such as letters of credit or credit lines. This catalog of potential mechanisms to reduce settlement risk describes some of the risk control measures actually in place in existing clearance and settlement systems for exchange-traded futures and securities transactions.

Establishment of a clearing organization for swaps and other types of OTC derivatives to reduce risks in such products has been a topic of discussion in the financial services community in recent years. However, there may be serious impediments to application of the risk reduction mechanisms of existing clearing organizations to non-standardized OTC derivative transactions. For example, multilateral netting by novation reduces the number of outstanding positions by offsetting fungible contracts against each other. However, in the swaps context, the offset functions performed by clearing organizations may be significantly less useful due to customization of products and the relatively low trading volume.⁸⁴ Questions have also been raised as to how a clearing organization would manage the risk of instruments, such as

⁸² See generally Organization for Economic Co-operation and Development, Systemic Risks in Securities Markets (1991) ("OECD") at 31 et seq.

⁸³ See Securities Transactions Settlement, 58 Fed. Reg. 52,891 (October 13, 1993) (SEC adoption of new rule establishing three business days as the standard for settlement timeframe for broker-dealer trades, effective June 1, 1995).

⁸⁴ See Minutes of the CFTC Financial Products Advisory Committee (August 5, 1993) at 17-19 (Remarks of John Davidson, Senior Vice President, Clearing House Division, Chicago Mercantile Exchange). See also Group of Thirty Report at 50.

swaps containing embedded options.⁸⁵

Further, as a variety of commentators have noted, the systemic implications of a clearing organization for swaps or other OTC derivative products would not be exclusively positive. Realization of an overall reduction in systemic risk through such a clearing facility depends significantly upon the construction of such a facility. A clearing organization centralizes risk management and counterparty credit assessment and acts as a "shock absorber," reducing counterparty risk for all market participants.⁸⁶ The consequences of a clearing organization failure likely would be "serious and pervasive" and might be assumed by market users to be of such gravity as to strongly suggest the likelihood of governmental intervention.⁸⁷ Thus, the concern has been expressed that a clearing system involving central guarantees of its members could give rise to moral hazard for participants, who may be inclined to be less rigorous in their own risk control measures in reliance upon the remedial intervention of third parties.⁸⁸

The CFTC's swaps exemption rules, as noted *infra*, contemplate arrangements for bilateral netting of both obligations and of payments and for multilateral netting of payment flows. The CFTC has stated that, although it believes multilateral netting of payment obligations can decrease systemic risk, the regulatory concerns relevant to such a facility, including equitable treatment of market participants, depend materially upon the specific design of such a system. Consequently, the CFTC's swaps exemption contemplates particularized applications for exemption of proposed swaps clearing facilities.

Legal Risk

Legal uncertainties are said to affect both the construction of OTC derivative transactions and the management of the risks they create. In the absence of exchange standardization of contracts or regulatory review of the terms and conditions thereof, OTC derivatives are wholly creatures of the counterparties' design.⁸⁹

⁸⁵ Sound risk management would require some method of measuring options risk but would have to be accomplished in the absence of a generally accepted source of volatility information, such as a centralized price reporting system, an exchange-traded surrogate product or sufficient volume of trades from which to extract reliable volatility data. *Id.*

⁸⁶ OECD, *supra*, at 34.

⁸⁷ *Id.*

⁸⁸ *Id.*

Legal risks may result from a single counterparty's legal incapacity to enter into a given contract or from an entire class of contracts being declared illegal or unenforceable. For example, the *Hammersmith & Fulham swaps* ruling⁹⁰ has been viewed as indicating that "the de jure ability of counterparties to perform cannot be taken for granted."⁹¹ Legal uncertainties could also arise in cross-border transactions where the legal status of the transaction in the counterparty's jurisdiction is not well-established.⁹²

Regulatory initiatives have been significant in enhancing certainty regarding the status of particular types of transactions and products. For example, even prior to obtaining statutory authority to exempt instruments with futures characteristics from the CEA's exchange-trading requirement, the CFTC took measures, including issuance of a policy statement creating a safe harbor for specified types of swaps, to enhance certainty as to the legal status of such transactions. Under exemptive authority granted by the FTPA, the CFTC has since issued rules to codify exemptions from most regulatory requirements for eligible swaps and qualifying energy contracts.⁹³

Uncertainties may also exist concerning the validity of netting arrangements designed to serve risk management purposes. The Promisel Report notes the strong desire expressed by banks for "clear, legally acceptable netting arrangements and their recognition for purposes of assessing capital standards."⁹⁴ Regulatory initiatives in this area have also been significant. The CFTC's Part 35 swaps exemptive rules specifically address the validity of arrangements for bilateral netting, both of obligations and payments, and for multilateral netting of payment flows. The exemptive rules also provide that application may be made to the CFTC for exemptions as to other types of netting arrangements on such terms and conditions as the Commission deems appropriate, including but not limited to "the applicability of other regulatory regimes."⁹⁵ This approach recognizes that the regulatory issues presented by multilateral

⁸⁹ Of course, even exchange-traded products or products subject to some form of regulatory review may be subject to legal uncertainty because even if regulators do not challenge the validity of the product, private litigants may do so.

⁹⁰ *Hazell v. Hammersmith & Fulham London Borough Council*, 2 W.L.R. 372.

⁹¹ Promisel Report, *supra*, at 18.

⁹² *Id.*

⁹³ See discussion of CFTC provisions for off-exchange transactions in Chapter II.

⁹⁴ Promisel Report, *supra*, at 18.

⁹⁵ 17 C.F.R. §35.2 (1993).

netting facilities would depend upon the design of such a facility. As the Promisel Report notes, although participation in a well-constructed netting arrangement can reduce risks, "participation in poorly designed ones can increase them."⁹⁶

Netting validity provisions enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991⁹⁷ are also important in this connection. These provisions are designed to assure the enforceability of netting contracts between specified financial institutions⁹⁸ and among members of clearing organizations registered as clearing agencies under the Securities Act of 1934, performing clearing functions for a contract market designated pursuant to the CEA, or in which all members other than the clearing organization are qualifying financial institutions or other clearing organizations.

The Basle Committee on Banking Supervision has issued for comment an exposure draft relating to appropriate netting arrangements which would adopt the Lamfalussy⁹⁹ standards for bilateral arrangements. The draft proposes similar standards be applied to multilateral arrangements if those are recognized as legally efficacious.¹⁰⁰ Although the legal authority to liquidate positions held with an insolvent counterparty has also been confirmed for many OTC derivative products,¹⁰¹ the legality of close-out netting is in doubt in certain foreign jurisdictions.¹⁰²

Operational Risk

Operational risk has been defined as the risk of loss due to inadequate systems and controls, management failure, or human error.¹⁰³ An operational failure of this nature, such as a failure to maintain rigorous management review of trading activity to assure that counterparty limits or other exposure limits

⁹⁶ Promisel Report, supra, at 36.

⁹⁷ 12 U.S.C. §4401-4407.

⁹⁸ Financial institution is defined to include a broker or dealer, a depository institution, a futures commission merchant, "or any other institution as determined by the Board of Governors of the Federal Reserve System." 12 U.S.C. § 4402(9).

⁹⁹ Bank for International Settlements, Report of the Committee on Interbank Netting Schemes of the Central Banks of the Groups of Ten Countries (November 1990).

¹⁰⁰ Basle Committee on Banking Supervision, Exposure Draft, The Supervisory Recognition of Netting for Capital Adequacy Purposes, (April 1993).

¹⁰¹ 11 U.S.C. §555 (securities contracts), 11 U.S.C. § 556 (commodities and forward contracts), 11 U.S.C. § 559 (repurchase agreements), 11 U.S.C. § 560 (swap agreements).

¹⁰² See Working Paper 3.

¹⁰³ See Group of Thirty Report, supra, at 50.

are observed, could increase the severity of other risks discussed above to the extent that it affects management of market or credit risk. Maintaining effective internal controls to assure that the risks of OTC transactions are appropriately managed is a key element of protection of other OTC counterparties because a failure to do so may affect creditworthiness. The Group of Thirty has observed that the complexity of OTC derivatives "requires special emphasis on maintaining adequate human and systems controls to validate and monitor the transactions and positions of dealers."¹⁰⁴ By comparison, in the context of conventional regulated products, firms performing intermediation functions generally are subject to segregation and/or capital requirements to protect against loss of customer funds, requirements for reporting of offsets and confirming trades, independent audit requirements which address material inadequacies in internal controls, and supervisory and other requirements that would tend to decrease the risk that management or internal control failures will go unnoticed and to ameliorate the consequences should such a failure occur. Even so, prophylactic regulatory requirements are not substitutes for managerial vigilance.

Generally, the data collected by the Commission concerning risk management procedures of OTC derivatives participants are consistent with the conclusions of other OTC derivative studies that participants in such markets recognize the importance of devoting substantial resources to the evaluation, monitoring and management, on a global basis, of the risks incurred in such activities.¹⁰⁵ However, there are differences across firms in the nature of their risk management practices. The Promisel Report cautions that, in the interbank and wholesale markets, "there is no single agreed best practice and, at many firms, significant gaps remain between the desired capabilities of risk management systems and the systems actually in operation."¹⁰⁶ Although most OTC derivative transactions currently may occur in firms with sophisticated evaluation and management systems, many have expressed concerns about the level of risk control in the less expert community. Operational risks may be compounded when liquidity constraints prevent the adjustment of portfolios in a timely manner.

¹⁰⁴ Id.

¹⁰⁵ See Promisel Report, supra, at 3; Group of Thirty Report, supra, at 18-19.

¹⁰⁶ Promisel Report, supra, at 3.

Potential Risks Arising from OTC Derivatives Activities Generally

The linkage between risks originating from individual firms, risks to other market participants and systemic risks may be more complex with respect to OTC derivatives than in exchange transactions because market-protective mechanisms to localize the consequences of individual firm failures are limited and prophylactic requirements to minimize the likelihood of such failures, are absent. As noted above, however, the failures experienced to date have not resulted in systemic problems.

Concerns about the possible risks of OTC derivative activity are not limited to those surrounding the consequences of individual firm failures or defaults. Concerns that are not specific to individual firm practices or risks center on certain common characteristics of derivatives transactions, the potential impact of derivatives activity upon other markets and the nature of the derivatives marketplace in the aggregate.

Size and Complexity

The rapidity with which the OTC derivatives markets have grown,¹⁰⁷ coupled with the evident complexity of the products in that marketplace, are imprecise yet significant signals that the systemic implications of OTC derivatives activity should be reviewed. However, although rapid growth may be conceded, observers debate the size of the OTC derivatives market relative to other markets and how best to measure it. For example, the Group of Thirty has described the OTC derivatives marketplace as "an activity that is large, but still modest in size relative to activities in other markets."¹⁰⁸ The complexity of OTC derivatives has also been discounted as not creating risks exceeding other extant economic risks and on the basis that derivative products must be "as complex as the risks they are created to manage."¹⁰⁹ The high degree of complexity of OTC derivatives, however, has reportedly rendered it difficult to identify and assess risk characteristics and obtain prices.¹¹⁰ For example, the SEC's net capital concept release states that "one of the more severe problems in measuring market risk is the possibility of mispricing

¹⁰⁷ See Chapter I at 10 (indicating, for example, a 28.5% annual growth rate in the number of interest rate swaps in the period 1990 to 1992). See also, Phillips, *supra*, noting that at six large dealer banks, gross unrealized gains on derivatives contracts equaled 15% or more of their total assets at year-end.

¹⁰⁸ Group of Thirty Report, *supra*, at 61.

¹⁰⁹ Working Paper of the Systemic Issues Subcommittee, Group of Thirty Report, *supra*, at 132.

¹¹⁰ e.g., Promisel Report, *supra*, at 18; Hu, *supra*.

[OTC] derivative products."¹¹¹ Further, it is observed that the introduction of new products into this marketplace "may involve a learning period during which many participants do not fully understand the product's risk properties."¹¹² Consequently, although not inherently a cause for concern, there is evidence of growing market activity presenting a degree of complexity sufficient to challenge the capabilities of market users to identify and manage the risks created and to warrant regulatory efforts to assess those risks and better identify the extent to which they merit regulatory attention.

Risk Concentration

A commonly voiced concern associated with the OTC derivatives market as a whole is that risks may have become highly concentrated in a small number of substantial participants which may include non-bank unregulated financial intermediaries.¹¹³ Very active dealers concentrate risk in a single entity. Some have suggested that such dealers, in that they stand between matching transactions as counterparties in both transactions, resemble individualized clearing organizations. On the other hand, dispersion of exposures among weaker credits would not necessarily strengthen the overall financial system. To the extent that regulators have addressed concentrations, they have imposed capital-based position limits or charges on large exposures for intermediaries and/or end-users.¹¹⁴ Futures exchanges also monitor such exposures of members through large trader reports and the pay and collect reports of across-market settlement exposure.

Concerns about concentration of risk have been associated with the evolution of the OTC derivatives marketplace from a brokered, or direct principal-to-principal market to one in which transactions generally are effected through dealers.¹¹⁵ Although many dealers are banks or other regulated entities,

¹¹¹ 58 Fed. Reg. 27,486 at 27,491.

¹¹² Promisel Report, supra, at 18.

¹¹³ See International Capital Markets, Part II, Systemic Issues in International Finance ("IMF Systemic Issues") International Monetary Fund (August 1993) at 31.

¹¹⁴ See, e.g., 58 Fed. Reg. 27,486 at 27,494. See also, the European Committee Capital Adequacy Derivative adopted on June 29, 1992, which addresses generally the minimum capital requirements for investment firms which are not credit institutions, the measurement of risk applicable to both investment firms and credit institutions, and the definition of capital, and which requires institutions to monitor and control their large exposures, that is, their exposures to individual clients and groups of connected clients.

¹¹⁵ Chapter I, supra.

others are not regulated. The unregulated status of these large OTC derivatives dealers has been described as "a supervisory hole at the very heart of the derivatives markets."¹¹⁶

Lack of Transparency

OTC derivatives transactions raise two types of transparency issues, those relating to the absence of widely disseminated price data and those relating to perceived inadequacies in financial disclosures by individual firms. The absence of a market discipline or regulatory requirement for reporting transactions to a central market facility is cited as a benefit by some market users¹¹⁷ but also gives rise to questions concerning the impact of price opacity on the effectiveness of risk management, upon liquidity in the event of individual firm difficulties or market stress and on the potential for "mispricing" an instrument. As a Group of Thirty Working Paper comments, "[t]he challenge of market risk management begins with proper valuation of derivatives portfolios."¹¹⁸ Consequently, reliable price information is integral to effective risk management.

Lack of price transparency in OTC derivative transactions also has been cited as a potentially exacerbating factor in periods of market turbulence. A paucity of reliable price information is viewed as potentially increasing liquidity strains because market-makers or other market users may be unwilling to commit capital to transactions without such data.¹¹⁹ The effects of price opacity upon liquidity may be particularly significant in the markets for highly customized, "exotic" instruments or for instruments of longer maturities due to the unavailability of a meaningful exchange transaction price as a reference price. At the same time, it has been noted that price transparency for such tailored instruments may be of little value, in any event, because of its limited relevance to pricing of other transactions.¹²⁰

With respect to balance sheet information, the Bank for International Settlements ("BIS") has

¹¹⁶Bank of England, supra, at ¶¶ 74-76. The Bank of England notes that there was "some feeling" on the part of one or two firms that such entities represented "unfair competition." Bank of England, supra, at ¶ 72.

¹¹⁷Schapiro, supra, (citing market secrecy as one of the features offered by the OTC market that standardized markets do not).

¹¹⁸Group of Thirty Report, supra, Appendix 1, Section 1 at 3.

¹¹⁹See also Promisel Report, supra, at 2.

¹²⁰See Schapiro, supra, at 9.

noted that the high degree of complexity of OTC derivative transactions and the reduced transparency of the balance sheets of firms engaged in such transactions tend to make it more difficult to assess the distribution of risk in these markets.¹²¹ There is also some concern about the potential for manipulation of "market" values to obtain desired results in the financial statements of a counterparty.¹²² For example, the Group of Thirty found that 40% of dealers and 70% of end-users do not disclose their accounting policies for derivatives in financial statements.¹²³ The Swaps Monitor reported that 60% of 110 U.S. dealers disclosed their book value in interest rate swaps at zero.¹²⁴ Some regulators, concluding that the increased use of derivative instruments, together with the limitations of current accounting concepts in this area, have "reduced the transparency of a firm's exposures, and of the financial system more broadly," have recommended development of "an agenda for reform" in this area, including creation of a steering committee on accounting and disclosure for derivatives.¹²⁵

The impact of incomplete disclosure of potential risks in individual firm balance sheets has been cited as a factor that may, during periods of market stress, exacerbate the strains on individual firms. A lack of complete information regarding individual firm risk exposures may cause counterparties to refuse to do business with, or seek to terminate existing business with, troubled firms and other firms believed to be similarly situated¹²⁶ and may hamper regulators' efforts to assist in minimizing the impact of such disruptions on regulated firms.

Market Liquidity Risk

Market liquidity is generally defined as the extent to which a large transaction in a particular product affects the price of the product. This risk has several aspects. The pricing impact of a large transaction increases the cost of hedging.¹²⁷ The assumption of liquid markets is important to rebalancing complex and dynamic hedges, especially where there are major shifts in volatility.¹²⁸ The Promisel Report

¹²¹ Promisel Report, supra, at 34.

¹²² See Working Paper 5.

¹²³ Group of Thirty Report, supra, Appendix I at 19.

¹²⁴ Id.

¹²⁵ McDonough, supra, at 8-9.

¹²⁶ Promisel Report, supra, at 1-2.

¹²⁷ Group of Thirty Report, supra at 46.

identifies several factors, including "a diminution of market-making capacity relative to total capital at risk in wholesale markets, increased transaction size, and aggressive short-term strategies" as resulting in dealers at times being "swamped" by one-way market moves.¹²⁹ Further, obtaining two-way prices near the market for all firms or for large transactions has become more difficult than in the past.¹³⁰

Daily market liquidity fluctuations have been distinguished from sudden liquidity declines in particular market sectors, for example, due to a sharp price movement or the withdrawal of a major market-maker. The Promisel Report notes that some North American and European firms believe that a sudden liquidity decline in a wholesale market segment could be a source of "potentially large problems," given the increased potential for such a liquidity problem to affect other markets as a result of closer linkages between markets and their primary participants.¹³¹ Other observers note that declines in liquidity in one marketplace could be counterbalanced by available liquidity in other markets. It has been observed, for example, that during more volatile periods, some volume shifts from OTC markets to exchange markets and that when a domestic exchange market closes, volume shifts to other markets that are open.¹³² Still other commentators have questioned whether these volume shifts are themselves disruptive.

The Group of Thirty Report expresses the view that OTC derivative liquidity has been "successfully tested in several situations of failure by large participants".¹³³ The Group of Thirty Report also notes that derivatives dealers are able to address the liquidity of customized products on an unbundled basis, *i.e.*, "a customized swap may appear to be illiquid, but if its component risks are liquid, then dealers will be willing to provide liquidity."¹³⁴ However, the Group of Thirty Report also notes that positions can become illiquid,

¹²⁸IMF Systemic Issues, *supra*, at 29 (August 1993). Dynamic hedging is based upon the theory that the price behavior of derivative instruments such as call or put options can be mimicked by that of a specific portfolio of positions, referred to as a synthetic option, in cash and in the underlying securities. "When a position in actual options is balanced by the opposite position for synthetic options, the overall position is perfectly hedged, but maintaining the hedge requires dynamic adjustment of the cash and underlying security positions, hence the term dynamic hedging." *Id.*

¹²⁹Promisel Report, *supra*, at 16.

¹³⁰*Id.* at 17.

¹³¹*Id.*

¹³²Schapiro, *supra*, at 14.

¹³³Group of Thirty Report, *supra*, at 62.

¹³⁴*Id.*

particularly in a crisis, that illiquidity can be a concern for market participants who hedge through a dynamic process, and that most dealers "have a healthy respect for illiquidity risk and take it into account in their risk limits or on a case-by-case basis".¹³⁵

Market Linkages

Many of the concerns expressed about potential liquidity risk and its systemic implications relate to the complex interconnections between OTC derivatives activity and other markets. Other studies of OTC derivatives have reflected the general concern of regulators, both domestic and international, about the linkages between OTC derivatives activity and other markets and among participants in OTC derivatives and other market sectors.¹³⁶ Although the empirical evidence does not support the view that derivatives cause volatility, it is true that the complementarities and dependencies among OTC derivatives and central markets are complex. All dealers interviewed in the course of this study qualified as large traders under the CFTC's large trader reporting system.¹³⁷ Most counterparties participate in both OTC and central market transactions. As a result, a failure of a counterparty with large exposures in the OTC market could affect the futures markets. Also, the prophylactic closing of a counterparty's positions in the futures market in the event of a threatened insolvency may leave that counterparty's OTC positions unbalanced and subject other counterparties to risk.¹³⁸

The significant presence of OTC derivative dealers in regulated futures markets indicates that for many such dealers, futures trading has become an integral part of their risk management practices.¹³⁹ At the same time, this interrelationship between the markets underscores the need for timely and accurate information including OTC risk exposures of major market participants in the event of a financial crises.¹⁴⁰

¹³⁵ Id.

¹³⁶ IMF Systemic Issues, supra, at 30-31.

¹³⁷ See Working Paper 2.

¹³⁸ See discussion of Drexel default in Working Paper 4.

¹³⁹ See Working Paper 2.

¹⁴⁰ McDonough, supra.

CHAPTER IV

RECOMMENDATIONS

The diversity of OTC derivative products and the corresponding diversity of their regulatory treatment render generic descriptions of these products, and identification of the potential systemic or public policy concerns they raise, complex tasks. As has been noted, the essence of the financial innovation process is that it unbundles and reconfigures characteristics of existing products into new instruments. As a result of more than a decade of financial innovation, the variety and complexity of OTC products challenge the marketplace as well as the regulators to master their operation and implications.

These are challenges, however, which the regulators have shown can be met, through a variety of initiatives designed to accommodate marketplace changes responsibly and flexibly. These efforts include both tailored exemptive criteria, such as the CFTC's swaps exemption, and the development of new information collection mechanisms, such as the CFTC and SEC risk assessment provisions, to afford greater access to data about sources of OTC derivative and other risks to regulated firms.

The object of the CFTC's review has not been to assess the efficacy of the discrete regulatory approaches to particular products developed to date but to consider the nature and implications of the OTC derivatives marketplace as a whole. Based upon this review, some general observations and recommendations for further consideration can be made.

The OTC derivatives marketplace is comprised generally of bilateral, privately negotiated transactions which are conducted in a manner that would render them exempt from most regulatory requirements. In general, these exemptions from regulation are premised upon the absence of a public offering or central market in which such transactions are traded and upon restrictions limiting participation to parties deemed qualified to transact without the protections afforded the general public by virtue of institutional or commercial status or financial resource criteria. Consequently, in these transactions, the disciplines and procedures imposed by market participants themselves take the place of otherwise applicable regulatory requirements to a significant extent. Entity-based oversight of banks, broker-dealers or other regulated parties to particular transactions may also be implicated.

Although no regulatory regime is generally applicable to all forms of OTC derivative transactions, the regulatory treatment of swaps may be cited by way of illustration. These transactions are not subject to regulatory requirements other than those contained in the CFTC's exemptive provisions, which provide for certain anti-fraud and anti-manipulation proscriptions. In order to fit within the scope of the exemptions, the transactions must be confined to parties who satisfy qualifying criteria that limit access to institutional or high net worth individuals.¹⁴¹ These limitations are consistent with the apparent contours of the market, under which public access appears to be precluded and the transacting parties enforce creditworthiness standards that may limit participation as much as, or more, narrowly than regulatory requirements. Similar treatment is accorded certain foreign exchange transactions.¹⁴² The Commission and certain other derivatives regulators recently have taken under consideration certain exchange requests to evaluate the level of protections to be accorded to sophisticated users of exchange derivative markets.¹⁴³

Cross-Jurisdictional Regulatory Coordination

It has been widely recognized that the linkages between stock index futures, options and securities markets render them, from an economic perspective, part of one market.¹⁴⁴ The growing use of OTC derivatives, particularly in conjunction with the use of regulated futures and securities exchange markets, may signal that an additional complex of financial market interrelationships links organized exchange markets, OTC derivative activity and potentially a variety of underlying cash markets. Many of the concerns articulated to date about the potential systemic risk created by OTC derivatives products are premised, in part, upon concerns about the extent of such interrelationships generally and any resulting potential for regulated markets and intermediaries to be adversely affected by OTC derivatives.

The cross-regulatory nature of the issues raised to date concerning OTC derivatives is thus clear. OTC derivatives are not readily cabined within any single regulatory structure. Equally, the systemic and

¹⁴¹ 17 C.F.R. § 35.1(b)(2)(1993) (definition of "eligible swap participant").

¹⁴² 17 C.F.R. § 32.4(a)(1993) (trade option exemption applicable to commercial offerees).

¹⁴³ Notice of Petitions for Exemptions for Certain Exchange Traded Futures and Options Contracts, 58 Fed. Reg. 43,414 (August 16, 1993). The Australian Securities Commission has undertaken a similar evaluation. See Draft Report on Over-the-Counter Derivatives Markets (Australian Securities Commission, July 1993).

¹⁴⁴ Report of the Presidential Task Force on Market Mechanisms (January 1988) at 55.

public policy issues suggested by these products are not confined to any single market or the province of any one regulator. In light of these factors, the Commission supports the establishment of an interagency council¹⁴⁵ to foster additional regulatory coordination in this area and to identify and consider common regulatory issues that may be raised by OTC derivative products.¹⁴⁶ A coordination mechanism of this nature is not intended to substitute for the individual initiatives of the relevant regulators, but rather, to supplement their individual efforts in areas of common interest. Based upon its review of this subject, the CFTC has identified the following issues as an agenda for further consideration on a coordinated basis by such a council of federal financial regulators.

Information Access

Studies of the OTC derivative marketplace commonly cite the difficulty of obtaining even basic information about OTC derivative transactions. Identification on a coordinated basis of information gaps and data needs could be an early focus of regulators' efforts in this area. Subjects about which additional information might serve to facilitate consideration of regulatory interests include the size and situs of

¹⁴⁵The Comptroller of the Currency recently suggested the creation of a task force to address certain derivative issues. See Speech of Eugene A. Ludwig, Comptroller of the Currency, Institute of International Bankers, September 27, 1993, at 4.

¹⁴⁶By way of example, following the extraordinary market events of October 1987, the President in March 1988 established an interagency Working Group on Financial Markets composed of the Chairman of the CFTC, the Chairman of the SEC, the Chairman of the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury (or their designees). Staff, administrative and support services necessary for the performance of the Working Group's functions are generally provided by each of the agencies involved, and the members of the Working Group serve without additional compensation for their work. The Working Group was charged with the responsibility to evaluate the numerous studies of the 1987 market events as well as to conduct its own independent inquiry. Based upon its evaluations, the Working Group was authorized to make recommendations to the appropriate agencies concerning what could be done within the existing regulatory framework to ensure the continued integrity, competitiveness and efficiency of the financial markets, and to recommend any legislative changes that it deemed appropriate. Exec. Order No. 12,631, 53 Fed. Reg. 9,421 (1988). The structure and functions of the Working Group could serve as a model for the creation of an interagency council of the type the Commission is recommending.

The Working Group resulted in agreement among the participating regulators and responses by the regulated markets concerning coordinated circuit breakers to allow for a cooling-off period during times of high market volatility; improvements in the credit, clearing and payments systems to avoid systems gridlock; and provisions for cross-margining between certain futures and options products. See also, letter from Senators Donald W. Riegle, Jr. and Alphonse M. D'Amato, Chairman and the Ranking Member of the Committee on Banking, Housing and Urban Affairs, to the Honorable Lloyd M. Bentsen, Secretary of the Treasury, dated September 23, 1993, regarding the continuing activities of the Working Group.

position concentrations in various types of OTC products; the extent of participation by regulated end-users, particularly collective investment vehicles such as pension plans, investment companies and commodity pools; price volatility and liquidity of OTC derivatives markets as compared to cash markets; and the nature of market linkages between OTC derivatives and futures and securities exchange markets generally.¹⁴⁷

Among other things, discussions could address:

- o what information or statistics are needed;
- o what information is available and where such information is located;
- o how information currently collected under risk assessment, capital or other authorities of the various regulators could be made more standardized;
- o whether more explicit lead regulator-type arrangements for the collection, exchange and monitoring of information could improve the usefulness and accessibility of information; and
- o the extent to which existing authorities are sufficient to satisfy data needs, especially as to unregulated end-users or unregistered or foreign entities performing intermediary functions.

Further, many of the studies of OTC derivatives focus upon the intermediation functions performed by dealers in swaps and other OTC derivatives products as potential sources of regulatory concern. Data collected by the CFTC support the conclusion that dealer transactions comprise an increasing proportion of OTC derivatives activity.¹⁴⁸ Market participants indicate that virtually all OTC derivative transactions are effected through dealers.¹⁴⁹ This trend may have some benefits in that market-making in wholesale markets reportedly "has become increasingly concentrated in firms that possess the size and expertise required to handle the risks profitably".¹⁵⁰ However, a Bank of England study has described the unsupervised status of some large dealer firms as a key weakness in the regulatory structure.¹⁵¹

Further information about large dealer operations may foster better comprehension of the relative

¹⁴⁷ See Bank of England at ¶¶89.

¹⁴⁸ See Chapter I, supra, Working Paper 1.

¹⁴⁹ Id.

¹⁵⁰ Promisel Report, supra, at 2.

¹⁵¹ Bank of England, supra, at ¶¶74-76.

benefits and risks of such dealer activity. Currently, federal regulators have multiple potential sources of access to data concerning OTC dealer firms. Federal banking regulators have access to information about bank dealer activities through special call reports and other existing supervisory mechanisms. The SEC and the CFTC have statutory authority to obtain information about affiliates of broker-dealers and futures commission merchants whose activities may pose material risks to the financial or operational stability of the regulated firm. Data available through these mechanisms may cover a very substantial portion of large dealers in the OTC derivatives markets.

To the extent that regulators determine that further information concerning unregulated dealer entities is desirable, consideration might be directed toward identifying the composition of the largest tier of such dealer firms, and their regulatory status, to determine the scope of unsupervised dealer activity. For example, in the context of a pending FRB proposal to include large financial products dealers within the definition of "financial institution" for purposes of the netting validation provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991,¹⁵² the FRB has identified a category of dealers whose operations could give rise to systemic consequences "in terms of losses to counterparties or market confidence and liquidity."¹⁵³

In addition, regulators may wish to consider the nature of the restrictions collectively imposed by market discipline and regulatory criteria upon access to OTC derivatives transactions, particularly as they may relate to participants in multiple markets or types of OTC transactions. Further, information concerning the presence of regulated entities--such as pension plans backed by federal insurance or investment companies--may be relevant to assessing the nature of the regulatory interests in this marketplace.

¹⁵² 12 U.S.C. §4401-4407.

¹⁵³ Under this proposal, qualifying dealers would include any person who participates actively in a financial market for its own account and holds itself out as a counterparty that will engage in transactions both as a buyer and a seller in the financial market and (1) who had one or more financial contracts of a total gross dollar value of \$1 billion in notional principal amount outstanding on any day during the previous 15-month period with counterparties that are not its affiliates; or (2) incurred total gross mark-to-market positions in one or more financial contracts of \$100 million on any day during the previous 15-month period with counterparties that are not its affiliates. Netting Eligibility for Financial Institutions, 58 Fed. Reg. 29,149, 29,150 (May 19, 1993).

Pricing, Disclosure and Risk Valuation Issues

OTC derivative transactions occur among dispersed dealers and, as a consequence, price and volume data may not necessarily be disseminated. The extent to which transaction prices are transparent may have implications beyond simply reflecting efficient prices. Price transparency may affect the ability of OTC derivatives market participants to establish reliable reference prices for daily or more frequent marking to market, now widely recognized as a critical risk management mechanism for dealer activities. The potential effects of a lack of reliable pricing data may be particularly acute where the transaction to be valued is of long duration or exotic construction, and prices generated for exchange-traded products are of limited utility. However, in the case of non-standardized OTC products, the extent to which price disclosure and transparency can be effective is questionable.¹⁵⁴

Price opacity may also affect the ability to unwind transactions in troubled markets or to rebalance position risk. Opaque markets such as those for OTC derivatives may tend to suffer greater liquidity strains during periods of market stress than transparent markets. This is because transactions are likely to be less attractive in the absence of a reliable price than when an exchange price or a reliable OTC price is available. It has also been noted that position concentrations at dealer firms can have significant effects on market liquidity if market-makers are unwilling to put the capital of their firms at risk. This is more likely to occur if there are significant price uncertainties. A further question involves the impact that OTC transactions may have on exchange markets if such OTC transactions move to exchange markets during periods of market turbulence. Potential linkages between OTC derivatives and exchange markets underlie the Bank of England recommendation that "relative price volatility and liquidity of cash and derivative markets" should be further studied.¹⁵⁵

Within the global securities community, market authorities have sought to analyze the determinants of market fairness and efficiency in secondary markets and the role of transparency in achieving these requirements. To date, market authorities have been unable to achieve consensus on the

¹⁵⁴Schapiro *supra*, at 15.

¹⁵⁵Bank of England, *supra*, at ¶89.

relative importance of the elements underlying transparency, or on the need for transparency in all markets. Essentially, one group believes that complete transparency should be a goal for all markets, whereas another group supports qualified transparency based on factors such as market structure and the size of the trade.

It may be possible for regulators to examine on a consolidated basis how best to assure reliable pricing information for risk management of OTC derivatives and to evaluate the relative usefulness of more information, especially for short-term so-called "plain vanilla" transactions.

Separately, the adequacy of financial disclosure by counterparties, in particular, end-users and unregulated intermediaries, has been questioned in some quarters and various proposals for reform of current accounting and financial disclosure regimes in this area have been made.¹⁵⁶ A review of common regulatory concerns in this area may be especially useful.

Internal Controls

CFTC regulations for FCMs, SEC regulations for broker-dealers, and federal banking regulators' supervisory standards for banks all create reporting and/or examination requirements relating to the identification of material inadequacies in regulated firms' internal controls. Although there are no corresponding regulatory requirements for OTC market participants generally, regulators and private organizations have devoted increasing attention to the importance of firms' internal control and risk management procedures as the first line of defense against OTC derivative risks. Basic risk controls include: marking of open positions to market on at least a daily basis; separation of risk management, credit assessment and trading functions; and prevention of deferral of loss reporting to management. The Bank for International Settlements has recommended giving increased managerial attention to "the role and position of risk control units, including internal and external auditors, vis-a-vis the operations they are supposed to control," to assure that risk control units have the necessary independence of and authority over the operations they are responsible for assessing.¹⁵⁷

¹⁵⁶ See generally, McDonough, *supra*.

¹⁵⁷ Promisel Report, *supra*, at 35.

Federal regulators could discuss how best to cooperatively reinforce the importance of such internal controls. For example, regulators could recommend that existing self-regulatory organizations for financial intermediaries under their supervision consider adopting guidelines or principles of conduct encouraging best internal control practices on the part of such SROs' member intermediaries and end-users. Member firms could likewise be encouraged to assure that the counterparties with whom they elect to do business also maintain adequate internal controls.

Clearing Facilities for OTC Derivatives

Proposals for clearing various types of OTC derivatives potentially raise a number of issues of common interest to federal financial regulators. For example, most counterparties participate in multiple markets, such that failures in one market may affect others. Coordinated discussion of cross-market issues that may be raised by clearing initiatives under the responsibility of the individual regulators is appropriate in light of the various intermarket interests potentially implicated.

Areas for CFTC Consideration

Consideration on a coordinated interagency basis of issues such as those set forth above should supplement, rather than supplant, the existing regulatory frameworks that the individual expert agencies are charged with administering. As noted elsewhere in this report, the independent initiatives of the various regulators, often acting in consultation with fellow regulators, have been significant in addressing areas of concern with respect to OTC derivative products.

The Commission has identified a number of areas of ongoing review relevant to OTC derivatives.

Clearing Facilities for Swaps

As noted above, various proposals for the development of clearing facilities for swaps, foreign currencies and other types of OTC derivatives have been discussed. The CFTC's exemptive provision for swaps, as discussed previously, does not pose a bar to such arrangements. It does, however, require that proposals for multilateral netting facilities, other than those limited to netting of payment flows, be submitted for review by the CFTC. In requiring that multilateral facilities be limited to netting of payments, absent specific exemption, the Commission nonetheless recognized the potential benefits of clearing

systems that mutualize risk and that a clearing mechanism for swaps could further the interests of the public as well as swap participants.¹⁵⁸ However, the Commission also recognizes that the regulatory issues presented by such a facility would depend materially upon the facility's design, such as, for example, the extent to which the construction of such a facility is consistent with the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Lamfalussy Report).¹⁵⁹ Therefore, swap clearing mechanisms would be most appropriately evaluated in the context of specific proposals.

Although no specific proposals for swaps clearing facilities have yet been submitted to the Commission, the Commission currently has under review, and has published for public comment, two exchange petitions which may raise certain related issues. Both petitions contemplate that exchange trading and clearing of transactions, limited to institutions or highly accredited individuals, would occur on a largely unregulated basis.¹⁶⁰ By comparison, the Commission's swaps exemption limits participation in eligible swaps to qualifying parties, but imposes few other constraints upon such transactions. The restriction against clearing facilities for multilateral netting of payment obligations reflects, in part, that such facilities may give rise to regulatory concerns beyond those presented by bilateral, individually-negotiated transactions involving individualized credit determinations.

FDICIA Netting Eligibility

A subject related to the possible development of a swaps clearing facility is the potential legal validity of netting processes undertaken by such a facility. The Commission has communicated to the FRB its support for extending the netting validity provisions of FDICIA to participants in any swaps clearing

¹⁵⁸ 58 Fed. Reg. 5587 at 5591 (January 22, 1993).

¹⁵⁹ Bank for International Settlements, Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (November 1990). See also, Basle Committee on Banking Supervision: The Prudential Supervision of Netting, Market Risk and Interest Rate Risk (April 1993).

¹⁶⁰ Notice of Petitions for Exemptions and Request for Comment, 58 Fed. Reg. 43,414 (August 16, 1993). The Commission notes that issues have been raised regarding whether the growth of unregulated OTC derivatives transactions has put regulated futures exchanges at a competitive disadvantage. The Commission intends to examine these issues closely as part of its consideration of these exchange petitions. These issues will also be examined in another Congressionally mandated study on competitiveness issues due next year.

facility the Commission may ultimately approve.¹⁶¹ The Commission intends to support applications that may be made to the FRB to extend FDICIA netting validity to CFTC-approved swaps clearing facilities and their participants in the interest of fostering certainty regarding the legal validity of netting effected through such a facility.

Risk Assessment

The CFTC requested and received authority in the FTPA reauthorization legislation, the Futures Trading Practices Act of 1992, to obtain information concerning the activities of affiliates of FCMs that are reasonably likely to have a material effect on the financial or operational condition of the FCM.¹⁶² The CFTC is proceeding with the development of rules to implement this authority, in consultation with the SEC and the FRB.

Treasury Amendment

As discussed in Chapter V of this report, recent litigation has raised important issues concerning the scope of the Treasury Amendment of the Commodity Exchange Act. The Commission will consider recommending to Congress legislation that would affirm the CFTC's view that the Treasury Amendment does not extend to the sale of futures or options on foreign currency to the general public.¹⁶³

Arkansas Best

For some time, the Commission has worked to eliminate uncertainty concerning the tax treatment of both regulated and unregulated derivatives used in business hedges. This uncertainty which has interfered with the efficient utilization of a variety of risk management strategies, has been engendered by the IRS's interpretation of the Supreme Court's decision in Arkansas Best v. Commissioner, 485 U.S. 212 (1988). Under the IRS interpretation, it was unclear to a business hedger whether the tax treatment on the gains and losses arising from the business asset or liability being hedged would be consistent with the tax treatment on the gains or losses arising from the derivatives forming the related hedge position. The

¹⁶¹Letter from Lynn K. Gilbert, Deputy Secretary, CFTC, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, dated August 20, 1993 (Comment letter, FRB Docket No. R-0801).

¹⁶²See Section 4f(c) of the CEA.

¹⁶³See Chapter V, infra.

Commission has been concerned that this situation would create inefficiencies and drain liquidity from the futures and options markets. Since April 1992, the Commission has urged members of Congress, former Secretary Brady and Secretary of the Treasury Lloyd Bentsen to take action to clarify the tax treatment of business hedges.

On October 18, 1993, the Treasury Department announced temporary and proposed regulations to address this issue. The Commission is greatly encouraged by this development, but notes that Secretary Bentsen stated in connection with release of these regulations that "[s]ome taxpayers may be disappointed that the regulations do not allow ordinary treatment for all business hedges." [emphasis in original]¹⁶⁴ The Commission intends to review closely the temporary and proposed regulations to determine if written comment on the regulations, is warranted to alleviate any remaining uncertainty which might adversely affect the U.S. derivatives industry.

¹⁶⁴Letter from Secretary of the Treasury Lloyd Bentsen to The Honorable Dan Rostenkowski, Chairman, Committee on Ways and Means U.S. House of Representatives, October 18, 1993.

CHAPTER V

THE PUBLIC POLICY IMPLICATIONS OF THE A-MARK AND TAUBER DECISIONS

The Decision of the U.S. Court of Appeals for the Ninth Circuit in *Bybee v. A-Mark Precious Metals, Inc.*, 945 F.2d 309 (1991)

As the Commission understands the facts developed by the courts in this litigation, in 1979, A-Mark Precious Metals, Inc. ("A-Mark"), a wholesale metals dealer, began doing business with Keith Bybee ("Bybee"), a retail metals dealer. As part of their dealings, A-Mark offered Bybee a "deferred delivery/margin" contract for the purchase of metals, which called for an immediate down payment (initially 20%, later changed to 10%) and for payment of the remaining balance within two years. The balance due A-Mark was secured by a lien on all undelivered metals bought under the deferred delivery plan.

Although the text of these deferred delivery contracts did not so provide, A-Mark was later found to have implicitly represented to Bybee that A-Mark would enter into offsetting contracts that would enable Bybee to settle in cash rather than through actual delivery of the metals.

Bybee did not extend any credit to his retail customers, and did not offer them any kind of deferred delivery contract like the contract between A-Mark and Bybee. In April 1982, Bybee began making margin purchases of silver from A-Mark for his own account. In addition, he began informing his customers that they need not take delivery of metals for which they had paid in full; that instead, A-Mark would store their metals free of charge for up to two years. The customers, however, were unaware that the metals purchased on this "storage" basis were subject to the terms and conditions of A-Mark's deferred delivery plan, including being subject to the lien securing all deferred delivery metals purchased by Bybee for his personal account.

As silver declined in value, A-Mark issued margin calls to Bybee who initially satisfied them from his personal assets. Later, he borrowed from friends and customers to meet further margin calls. By May 1986, Bybee was unable to satisfy new margin calls, and resold all metals that he had purchased on margin, including the metals that Bybee's customers had paid for in full but were being "stored" at A-Mark. After deducting Bybee's indebtedness, A-Mark remitted to Bybee approximately \$300,000 which he then

invested in the futures market and lost. Soon thereafter, Bybee filed for bankruptcy under Chapter 7 of the Bankruptcy Code.

The bankruptcy trustee filed a complaint against A-Mark, seeking to recover all money Bybee and his customers had lost in connection with the A-Mark/Bybee deferred delivery purchases. The trustee charged that A-Mark's deferred delivery contract was an illegal off-exchange futures contract sold in violation of the CEA. The bankruptcy court concluded that A-Mark's contract was not a futures contract because it was not offered to the general public by A-Mark, directly or indirectly. Accordingly, the court denied the trustee any recovery on this claim. The trustee then appealed to a U.S. district court which ruled that A-Mark's contract had "all the indications of a futures contract save one: the public was not involved." (Slip Op. at 11). Accordingly, the district court concluded that A-Mark's deferred delivery contract was not a futures contract; rather, it was a cash forward contract excluded from CEA regulation by Section 2(a)(1)(A) of the CEA. The trustee then appealed to the Court of Appeals for the Ninth Circuit, urging it to find that A-Mark's contract was a futures contract.

In the court of appeals, the Commission filed a brief as an amicus curiae. In its brief, the Commission did not express a view on whether the A-Mark/Bybee agreements were futures or cash forward contracts. Rather, the Commission argued only that the district court had erred in holding that public participation is a determinative element of a futures contract.

On September 27, 1991, a three-judge panel of the court of appeals stated that the deferred delivery contracts marketed by A-Mark to Bybee were futures contracts under the CEA.¹⁶⁵ Nonetheless, the court held that the CEA's prohibition against off-exchange futures trading did not apply because the A-Mark/Bybee contracts came within the cash forward contract exclusion of the CEA. The court therefore affirmed the district court's ruling not to set aside these contracts as violating the CEA. In effect, the court ruled the contracts to be both futures contracts and forward contracts.

In the Commission's view, a particular contract may not be deemed to be both a futures contract

¹⁶⁵The court of appeals agreed with the position taken by the Commission in its amicus brief that the district court had erred in holding that public participation is a determinative element of a futures contract.

and a cash forward contract under the CEA. Specifically, the CEA expressly declares that "[t]he term 'future delivery' ... shall not include any sale of any cash commodity for deferred shipment or delivery,"¹⁶⁶ i.e., a cash forward contract. To the extent the A-Mark opinion may be read to conflict with this statutory command, the Commission would view it as an impermissible interpretation of the CEA.

The Commission has taken the view that neither its law enforcement efforts nor those of the states should be adversely affected by the confused decision in the A-Mark case. The Commission understands that no members of the general public were sold the A-Mark deferred delivery contracts and that both A-Mark and Bybee can be fairly characterized as commercial precious metals dealers. Therefore, the A-Mark opinion should provide no comfort to boiler room operators or others who might seek to claim a cash forward exclusion to fend off investigations and prosecutions while victimizing the public through the sale of off-exchange futures contracts. The Commission has advised the North American Securities Administrators Association that it fully intends to continue to work with its members, and other state and federal law enforcement officials to prosecute illegal off-exchange futures sales fraud under recognized legal precedents, such as CFTC v. CoPetro Marketing Group, 680 F.2d 573 (9th Cir. 1982), another Ninth Circuit decision which the A-Mark Court endorsed.

Nonetheless, the Commission remains concerned about the court's unprecedented expansion of the forward contract exclusion to cover agreements where delivery of the commodity apparently was not contemplated by the parties, and where A-Mark represented that it would provide for offsetting contracts without the need for delivery. As acknowledged by the A-Mark appeal panel, the Commission continues to interpret the forward contract exclusion as limited to transactions between commercial parties, who have the capacity to make or take delivery, and which are undertaken in connection with the conduct of the parties' businesses.¹⁶⁷ In this regard, it is noteworthy that all or virtually all off-exchange boiler rooms the

¹⁶⁶The forward contract exclusion was set forth in section 2(a)(1)(A) of the CEA at the time the Court decided the case. The Futures Trading Practices Act of 1992 has since recodified the exclusion as section 1a(11) of the CEA.

¹⁶⁷See A-Mark, 945 F.2d at 314 n. 5, citing Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,191 (Sept. 25, 1990). See also Exemption for Certain contracts involving Energy Products, 58 Fed. Reg. 21,286 (April 20, 1993).

Commission has prosecuted have used contracts that purportedly require the parties to make or take delivery.¹⁶⁸ Thus, a formalistic emphasis on the written terms of a contract could result in case law inhibiting the Commission's ability to combat fraud.

Moreover, the Commission is troubled that Bybee's status as a commercial party, and his ability to perform on the contracts, were accepted by the court without discussion. In this regard, it is instructive to look to Section 502 of the FTPA in which Congress gave the Commission the authority to grant exemptions from the exchange-trading requirement and other provisions of the CEA. That exemptive power extends only to transactions between sophisticated or financially sound corporate entities, or such other persons that the Commission determines are appropriate in light of financial or other qualifications. For all of these reasons, the Commission will monitor carefully how the A-Mark decision is used by litigants and interpreted by courts.

The Decision of the U.S. District Court for the Eastern District of Virginia in Salomon Forex, Inc. v. Tauber, 795 F.Supp. 768 (1992), aff'd, No. 92-1406 (4th Cir. October 18, 1993)

Based on the record developed in this litigation, the Commission understands that from 1987 to 1991, Dr. Laszlo Tauber, a general surgeon practicing in northern Virginia who has a net worth exceeding a half-billion dollars derived from real estate holdings across the United States, engaged in off-exchange foreign currency transactions including swaps, forwards and option contracts with Salomon Forex, Inc. ("Salomon Forex"), a foreign currency brokerage company. During this period Tauber, who was Salomon Forex's only non-institutional client, generally provided collateral usually consisting of letters of credit or secured interests in other assets for the foreign currency contracts made with Salomon Forex. In 1991, Tauber failed to adequately secure \$25,831,452.01 in collateral for sixty-eight contracts that matured in July and August of that year. As a result, in September 1991, Salomon Forex brought an action in the U.S. District Court for the Eastern District of Virginia against Tauber seeking this sum in damages. Tauber counterclaimed against Salomon Forex, challenging the validity of the sixty-eight contracts and 2,632 other

¹⁶⁸Typically, the boiler room operator orally represents to the customer that, notwithstanding the terms of the contract, the obligation to make or take delivery can be avoided with an offsetting transaction or a cash payment.

foreign currency contracts under the CEA as well as state law.

On June 5, 1992, the district court ruled that the foreign currency transactions between Tauber and Salomon Forex were not unlawful off-exchange futures contracts because they were "transactions in foreign currency" for future delivery covered by the exclusion from all CEA provisions found in what is known as the "Treasury Amendment."¹⁶⁹ The Treasury Amendment excludes from the CEA's coverage certain enumerated transactions, including "transactions in foreign currency," unless such transactions "involve the sale thereof for future delivery conducted on a board of trade."

The court interpreted the Treasury Amendment exclusion very broadly. It read the phrase "transactions in foreign currency" to mean "any transaction, without limitation as to the participants involved, in which foreign currency is the commodity or subject matter, much as one would speak of transactions in flaxseed or wool tops." 755 F. Supp. at 773. Having determined that the disputed contracts were within the Treasury Amendment exclusion and therefore were not unlawful under the CEA, the court granted Salomon Forex summary judgment against Tauber. Tauber appealed to the Court of Appeals for the Fourth Circuit and the Commission filed an amicus curiae brief taking issue with this aspect of the district court's decision.¹⁷⁰

In the Commission's view, the district court went beyond the facts of the case before it by holding that all transactions in which foreign currency is the actual subject matter of an off-exchange contract for future delivery are excluded from the CEA under the Treasury Amendment. 795 F. Supp. at 776. The Commission believes this interpretation is at cross-purposes with the 70-year old regulatory scheme that Congress has fashioned for futures trading.

Beginning with enactment of the Grain Futures Act of 1922, Congress has recognized a national public interest in the trading of commodity futures contracts particularly as a risk shifting mechanism, and in the quotation and dissemination of the prices of such contracts which are used as a basis for

¹⁶⁹At the time of the district court's ruling the Treasury Amendment was codified in the CEA in section 2(a)(1)(A). By virtue of the FTPA, it now appears as section 2(a)(1)(A)(ii).

¹⁷⁰The district court also found that currency options transactions do not become a transaction "in" that currency until the option has been exercised. Since Dr. Tauber's currency options had been exercised, the court concluded that the Treasury Amendment exclusion applied.

determining the prices of commodities in interstate commerce. In addition, Congress historically has endeavored to eradicate the proliferation of notorious operations, notably "bucket shops," which serve no economic utility.¹⁷¹ See 61 Cong. Rec. 1318 (1921) (statement of Rep. Voight) ("The bucket shop is wiped out in this bill, because a bucket shop is not a contract market."); 132 Cong. Rec. S17,023 (Oct. 17, 1986) (statement of Sen. Melcher) ("The mayhem caused by commodity bucket shops is what caused Congress over sixty years ago to create a broad futures contract definition and require all lawful futures to be traded on federally approved exchanges.").

Today, the CEA generally requires that all futures trading in the United States be conducted on a CFTC-designated contract market.¹⁷² The legislative record also shows that the Treasury Amendment was meant to be a limited exception to the CEA and was never intended to permit the marketing of foreign currency futures to the public. As the Seventh Circuit succinctly put it:

From the legislative history, it is quite clear that the Treasury amendment was adopted by Congress only to prevent dual regulation by the CFTC and bank regulatory agencies of banks and other sophisticated institutions that ordinarily trade in enumerated financial instruments.

Board of Trade of City of Chicago v. S.E.C., 677 F.2d 1137, 1154 (7th Cir.), vacated as moot, 459 U.S.

1026, 103 S.Ct. 434

(1982).¹⁷³

The district court's novel and broad construction unnecessarily jeopardizes the regulatory regime that generally requires that all futures trading take place on CFTC-designated exchanges or subject to

¹⁷¹"Bucket shop" refers to a firm purporting to conduct a legitimate exchange business which actually accepts bets on the price movement of commodities. When the market moves against the bucket shop operators, they often close their shops in haste or file for bankruptcy protection, leaving a trail of uncollectible debts. See e.g., Gatewood v. North Carolina, 203 U.S. 531, 536 (1906).

¹⁷²See Sections 4(a) and 4h of the Act, 7 U.S.C. §§ 6, 6(h). A "contract market" is a board of trade or exchange designated by the Commission to trade futures or options under the CEA. See 7 U.S.C. §§ 7, 7a; 17 CFR Part 33.

¹⁷³This decision was vacated as moot because Congress resolved the jurisdictional issue in the case. However, the opinion continues to be relied on by the Seventh Circuit as authoritative. See Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989), cert. denied, 496 U.S. 936 (1990).

One other court of appeals as well as a district court have agreed with the Seventh Circuit and the Commission that the scope of the Treasury Amendment exclusion is limited. See CFTC v. Am. Board of Trade, 803 F.2d 1242, 1249 (2d Cir. 1986); CFTC v. Sterling Capital Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶121,169 at 24,784 (N.D. Ga. 1981).

carefully crafted exemptions. The district court's decision could be read to permit any firm to market to the general public off-exchange futures contracts in foreign currency completely free of federal regulation.

Bucket shops and boiler rooms, the very types of fraudulent businesses Congress sought to outlaw in enacting the CEA, are likely to follow.¹⁷⁴

This concern about the Commission's ability to prosecute bucket shops is not merely theoretical. In fiscal year 1993 alone, the Commission brought five enforcement actions alleging that persons and firms were engaged in the offer and sale to the general public of illegal off-exchange foreign currency futures and options contracts. These included one case filed with the State of California as co-plaintiff.¹⁷⁵ Decisions adopting the district court's reasoning in Tauber could impair the Commission's ability to bring such actions in the future. Indeed, should other courts accept the district court's broad reading of the Treasury Amendment, it would effectively eliminate the Commission's ability to combat these types of operations.

The reading of the Treasury Amendment adopted by the district court in Tauber was rejected in a recent opinion by the United States District Court for the Eastern District of New York in CFTC v. Standard Forex, Inc., No. CV 93-0088 (August 8, 1993) (appeal pending). Standard Forex is a Commission enforcement action against Standard Forex, a New York corporation, and 11 individuals who were associated with or employed by the firm. The complaint alleges that the firm and each of the individuals marketed illegal off-exchange foreign currency futures contracts to members of the Chinese-American community, and committed fraud in the offer and sales of those contracts. The complaint also charged the firm with illegally operating as an unregistered futures commission merchant. In its August 9, 1993 order, the court denied motions to dismiss by certain of the defendants who argued, relying extensively on Tauber, that the Commission lacked jurisdiction to pursue its action because of the Treasury Amendment.

¹⁷⁴Moreover, in addition to currency, the Treasury Amendment covers transactions in security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, and mortgages and mortgage purchase commitments. The court's reasoning, if applied to these other instruments enumerated in the Treasury Amendment, could lead to boiler room operations in all of them.

¹⁷⁵The five cases are CFTC v. Standard Forex, Inc., No. CV 93-0088 (E.D.N.Y. 1993) (discussed in more detail below); CFTC v. Pacific Bullion (New York), Inc., Misc. No. 92-259 (E.D.N.Y. 1992); CFTC and the State of California v. Pundi-Forsten International (Holdings), Ltd., Civ. No. 93-0067 RMT (C.D. Cal. 1993); CFTC v. Richwell International, Ltd., C93-3494 EFL (N.D. Cal. 1993); and In re Wong, CFTC Docket No. 93-8 (May 21, 1993).

The court also granted the Commission's motion for a preliminary injunction.

The defendants argued, in essence, that the Treasury Amendment clearly and expressly exempts all transactions in foreign currency from the Act, except for those transactions conducted on exchanges designated by the Commission. In rejecting this argument, the Standard Forex court held that "[a]pplying well-settled canons of statutory construction leads to the initial conclusion that the [Treasury Amendment] is ambiguous on its face and that congressional intent must be deduced from the available legislative history." In analyzing the legislative history, the court noted that in 1974 Congress extended CEA protection to previously unregulated markets on behalf of unsophisticated and private investors. Although it acknowledged that the Treasury Amendment was an attempt by the Department of Treasury to pare down the scope of the CEA, the court concluded that, when it was enacted in 1974, the Treasury Amendment was intended to exclude only interbank transactions.

The court in Standard Forex "respectfully disagree[d]" with the district court's decision in Tauber. The opinion in Standard Forex concludes that the Tauber court failed to consider the ambiguity created by the use of the term "board of trade." Rather, the Tauber court simply and wrongly assumed that, because the transactions at issue were "off-exchange," they could not have been executed on a board of trade.

In addition, the court in Standard Forex buttressed its conclusion by deferring to the Commission's analysis of the Treasury Amendment in its Statutory Interpretation Regarding Trading in Foreign Currencies for Future Delivery, 50 Fed. Reg. 42,983 (Oct. 23, 1985). That interpretation states that "the Amendment was meant to encompass only transactions among and between banks and other sophisticated and informed institutions." The court also rejected the Treasury Department's interpretation, as set forth in its amicus curie brief to the Fourth Circuit in Tauber. In the court's view: (1) the Treasury Department is not charged with enforcing the CEA or the "exempt realm" marked by the Treasury Amendment; and (2) the concerns expressed by the Treasury Department focus only on trading in government securities markets. Therefore, Treasury's arguments "do not contribute to understanding the congressional mandate bestowed on the [CFTC]." Thus, the court concluded that any marketing of futures transactions in foreign currencies to the general public is outside the scope of the Treasury Amendment's exclusion.

On October 18, 1993, the United States Court of Appeals for the Fourth Circuit decided the appeal in the Tauber case. While it affirmed the judgment of the district court, the Court of Appeals made clear that its action was not intended to "result in the use of this circuit as a base for marketing off-exchange futures contracts to the general public." Slip op. at 19.

In interpreting the Treasury Amendment, the Court sought to find the plain meaning of the provision based on the assumption that "the legislature used words that meant what it intended." Slip op. at 14. The Court found the phrase "transactions in foreign currency" to be broad and unqualified, reaching not only transactions in the commodity itself but all transactions in which foreign currency is the subject matter, including futures and options.

The court also reviewed the Treasury Amendment's legislative history, which in its view reveals that the Amendment was added to protect the informal network of established dealers in foreign currency-based investments and was not therefore limited to the interbank market.

What the statute commands instead is the exemption of all trading off organized exchanges, including the entire informal professional trading network of which banks are a key part. As the trading between Salomon Forex and Tauber consisted of large-scale, customized, negotiated, bilateral transactions between sophisticated financial professionals, it falls within this classification and is not included within CEA coverage. Slip. op. at 18.

In this regard, the Court rejected Tauber's argument that affirmance of the district court would serve as a basis for marketing off-exchange futures contracts to the general public. Citing the district court's decision in Standard Forex, the Court observed that the Tauber case does not involve mass-marketing to small investors "which would appear to require trading through an exchange" and emphasized that "our holding in no way implies that such marketing is exempt from the CEA We hold only that individually-negotiated foreign currency option and futures transactions between sophisticated, large-scale foreign currency traders fall within the Treasury Amendment's exclusion from CEA coverage." Slip op. at 19.

The Commission believes the court of appeals decision in Tauber correctly recognizes that the Treasury Amendment exclusion from the CEA does not reach the offer or sale of futures or options to the general public. Nevertheless, while reaching a conclusion consistent with the district court decision in Standard Forex, the court of appeals' legislative analysis is inconsistent in some respects. In view of the prevalence

of litigation over the scope of the Amendment and the lack of unanimity in the courts over its precise contours, the Commission will consider recommending to Congress legislation that would affirm the CFTC's view that the Treasury Amendment does not extend to the sale of futures or options on foreign currencies to the general public.

CHAPTER VI

ANALYSIS OF A SINGLE REGULATOR FOR DERIVATIVES, FUTURES AND SECURITIES

Introduction and Background

The Conference Report on the Futures Trading Practices Act of 1992 requested that the Commission study "whether a single Federal regulatory agency should regulate the exchange or off-exchange trading of, and markets for, futures, options, swaps, derivative products and securities." H.R. Rep. N. 978, 102d Cong., 2d Sess., 83 (1992). The issues involved in determining the federal regulatory structure appropriate to the markets for commodity futures and options, securities and off-exchange derivative products are complex. Some have suggested a complete overhaul of the U.S. financial regulatory system, including revision to the banking and securities regulatory structures. While the following discussion concentrates primarily on the issues which might be raised by merging the SEC and the CFTC,¹⁷⁶ it should also be considered within the broader perspective of the ongoing innovation taking place throughout the financial services industries.

Commodity futures and option contracts are, and historically have been, risk-shifting instruments. In contrast, securities have historically been capital formation vehicles. The existing regulatory structures for commodity futures and options and for securities, therefore, grew out of the separate historical functions served by these two industries. In this regard, it should be noted that federal regulation of futures markets began as early as 1914 with the regulation of cotton futures. This was followed by legislation in 1921, 1922, and 1936 regulating futures trading in domestic agricultural commodities. In 1974, Congress created the CFTC and reaffirmed the principles embodied in the 1936 Commodity Exchange Act. In particular, the requirement that futures contracts must be traded on a designated exchange was strengthened and extended. The development of securities regulation followed a separate evolution under the Securities Act of 1933, the Securities Exchange Act of 1934, and other related legislation.

As these two legislative approaches developed, the focus of each regulatory framework was clear--

¹⁷⁶In this regard, a bill has been introduced to effect such a merger between the CFTC and the SEC. See H.R. 2550, 103rd Cong., 1st Sess (1993).

evolving along identifiable lines based on the distinct type of economic activity being regulated.

Accordingly, the CFTC, and its predecessors, were charged with regulating price discovery and risk-shifting activities, and the SEC was charged with regulating capital formation and related investment vehicles.

Although federal regulation of commodity futures and options historically had focused on domestic agricultural commodities, the continued evolution in these markets prompted Congress, in 1974, to expand the scope of that regulation. Already, the first unregulated futures contracts on foreign currencies had begun trading on exchanges, and new contracts on other financial instruments and various services were being considered. Moreover, marketing of various commodity options was unregulated, and fraud in those markets was causing serious concern.

Thus, Congress was faced with the question of whether these newly developing futures and option contracts, regardless of the underlying commodity, should be regulated, and if so, by what regulator. After extensive study, the Congress determined that all futures and commodity option contracts, regardless of the underlying commodity, had the same economic function and should be regulated by a single, independent agency administering the Commodity Exchange Act: the CFTC.¹⁷⁷

Since 1974, trading in futures contracts based on financial products has grown relatively faster than those based on the more traditional, physical commodities, like grains or precious metals. Today, financial futures account for over one-half of total annual futures volume on U.S. exchanges.¹⁷⁸ In addition to stock indexes and other financial futures, however, new futures contracts on physical commodities, like crude oil, gasoline and heating oil, have also grown into very major markets. Regardless of the nature of the underlying commodity, however, all futures trading serves the same economic purposes. The CEA reflects this reality by prescribing a regulatory structure equally applicable to wheat futures, gold futures and stock index futures.

With the growth of financial futures, especially futures on stock indexes, and the introduction of

¹⁷⁷ See, e.g., H.R. Rep. No. 975, 93rd Cong., 2d Sess. at 44 (1974) ("the necessity to bring all futures, from whatever source, into the regulatory fold should make adequate allowance for independent input outside of the Department [of Agriculture]"). See also S. Rep. No. 850, 95th Cong., 2d Sess. at 10 (1978).

¹⁷⁸ Futures on stock indexes account for about 5% of the trading volume on U.S. exchanges.

stock index options regulated by the SEC, the issue of whether to maintain separate regulators for futures and securities has been raised. In part, those raising this issue pointed to questions arising from the stock market breaks in 1987 and 1989. Questions also arose in connection with the introduction of new instruments, beginning in the late 1980's. These instruments, discussed more fully above in Chapter II, include: hybrid products, which combine elements of commodity futures or option contracts with debt or depository interests; swaps; and other types of transactions which may not clearly fall within either the CFTC's or the SEC's jurisdiction. These events have suggested that financial innovation will produce products that cross or fall outside jurisdictional boundaries, requiring new regulatory approaches. However, that does not mean that the restructuring of the current regulatory frameworks is necessitated by these developments.

Regulators have not been complacent during this period of change in the financial services industries. They have responded flexibly within the current regulatory frameworks to keep pace with these market changes. The CFTC has taken innovative steps to address issues raised by the introduction of new instruments. For example, promptly after receiving exemptive authority in late 1992, the CFTC provided exemptive relief for three classes of transactions. This relief exempted certain swaps, hybrids and energy contracts from the exchange-trading requirement and other regulatory provisions where participation in the exempted transactions is restricted to persons who satisfy commercial, institutional and/or asset standards.

In addition, the regulators have responded to the increased linkages between the financial futures and options markets and other financial markets by increasing cooperation and coordination. In this regard, the CFTC, SEC, Treasury Department and Federal Reserve System staffs regularly communicate on both a formal and informal basis regarding the markets and institutions which each regulates. This cooperation extends beyond mere information sharing and has included joint CFTC/SEC regulatory initiatives and investigations. Moreover, this spirit of cooperation has also been successfully encouraged among the various futures and securities self-regulatory organizations overseen by the government regulators.

Almost twenty years have passed since Congress' initial determination to create a single, independent regulator for all futures and commodity option contracts. Although the markets have changed dramatically, the regulators have continued to respond flexibly.

Merger of Regulatory Frameworks

A proposal to merge the CFTC and the SEC could take varying forms. For instance, one could simply merge the two agencies, while maintaining the separate and distinct regulatory structures that exist under current law. Alternatively, an effort could be made to unify the differing regulatory frameworks.

This latter alternative is a more complex approach. Some suggested in the wake of the 1987 stock market break that stock index futures should be regulated under the same regulatory scheme as the underlying securities markets. They argued that stock index contracts and the underlying securities markets were functionally similar, and should therefore be regulated identically. In addition, some argued that such a unification of the regulatory frameworks would benefit certain interests who trade in both markets. For instance, many FCMs are also registered as securities broker-dealers. Some made the argument that operating under one set of rules, rather than two, would result in some savings and administrative simplification.

However, as is discussed below, that may not be the case.

After considerable study of the issue at that time, Congress, and most observers, recognized that, although linked, the two markets serve different functions and consequently, that separate regulatory schemes are necessary. In particular, it was recognized that there are fundamental differences between these markets. Futures and options are derivative instruments which historically have traded in a centralized auction environment that provides a mechanism to shift price risk and to discover prices. In contrast, apart from options, most types of securities are not derivative instruments and can be transferred directly between individuals, over-the-counter or on exchanges. Furthermore, the purchase and sale of most securities, including stock options, reflect a judgment about the value of a single company. The present regulatory frameworks are an outgrowth of these significant differences.

Accordingly, the structure of the Commodity Exchange Act is primarily directed to oversight of

trading on the futures exchanges and commodity professionals engaged in transactions on behalf of customers. In this regard, the Commission closely monitors world-wide supply and demand factors and surveys the markets for congestion or other pricing distortions during delivery periods. In furtherance of that function, the CEA provides the Commission with wide-ranging emergency powers to affect trading in the markets. In contrast, the primary focus of securities laws is to regulate the offer and sale of a particular company's debt or equity instruments to the public and the secondary market trading of those instruments, whose historical value is a reflection of the company's business success.

Secondly, futures and options markets are equally important to hedgers seeking protection against price decreases and to those seeking protection from price increases. Therefore, the Commodity Exchange Act and CFTC regulations for futures and options favor the concept of price neutrality--that is, the idea that derivative markets should accurately reflect the cash market price, whatever direction that price is moving. Securities regulation on the other hand, tends to favor upward movements in the value of the investment. Thus, for example, securities regulation has rules discouraging short-selling on a down tick, while futures markets have no comparable rule.

In addition to these fundamental differences, even where the two regulatory frameworks are not necessarily inconsistent, there may, nevertheless, be irreconcilable differences in specific regulations which, if unified, would adversely affect one market or the other. For example, commodity pools, as presently structured, would likely be unable to operate if they were required to comply with the prohibition of leverage and other requirements of the Investment Company Act of 1940, such as those regarding corporate structure, restrictions on the type of permissible investments and methods of operation.

Even were it possible to unify the two regulatory schemes, there would appear to be few advantages in doing so. First, the potential savings and administrative simplification from unifying the two statutory schemes can be easily overestimated. Any such savings would be proportional to the degree of duplication of the existing rules of the two agencies. In this regard, it should be noted that the CFTC and SEC have actively worked to avoid duplicative rules wherever appropriate. For example, the two agencies have long-since harmonized the capital requirements for FCMS and securities broker/dealers. Accordingly,

a formal merger of SEC/CFTC rules would produce little, or no, savings in this area.

A second presumed advantage from merging regulatory schemes is that a single scheme could avoid the problem of determining which scheme applies to a new hybrid instrument. However, instruments yet to be developed, and even some existing hybrids, may not fit within a unified CFTC/SEC regulatory framework. New instruments introduced in the late 1980's and early 1990's sought to combine aspects of both securities and commodity futures and option contracts with depository instruments. Unifying the CFTC's and SEC's statutory frameworks would not provide a solution with regard to instruments which have a bank product component. Other products may be neither futures nor securities, thus falling wholly outside both statutory frameworks. Finally, hybrid instruments comprise only a small portion of either agency's responsibility.

Rather, the nature of regulation of hybrid products which combine aspects of multiple instruments should depend upon an assessment of the regulatory interests implicated by the instrument. This interest should not be defined by who regulates the instrument, but by the instrument's essential character and the nature of the market in which it trades. Thus, although many of the existing hybrid instruments presented difficult regulatory issues, it was generally not impossible for them to fit into the existing regulatory frameworks. Furthermore, the recent amendments to the Commodity Exchange Act granting the CFTC the authority to exempt instruments from the Act have provided the Commission with a far more flexible means to address issues raised by the introduction of new instruments.

Merger of the Regulators

Some suggest that merging the two regulators into one agency would avoid the potential for interagency debate or disagreement. Even if this were so, however, there remains a question whether intra-agency communication, cooperation and coordination is inherently better than inter-agency activity. A single regulator would have to face the same issues now addressed by separate regulators, such as the determination of the appropriate regulatory scheme for a new product. Such issues are likely to occur where the various statutes are not in complete harmony, and where a decision may result in an advantage to one industry over the interests of another.

It is not at all certain, however, that a merged regulator will resolve such an issue more expeditiously, or that it will be more likely to avoid a litigated resolution. To the extent that there are real consequences emanating from the decision as to which regulatory framework applies, private litigants likely will challenge agency decisions which they perceive to disadvantage them. Accordingly, a merged regulator may still find itself in court arguing the jurisdictional boundaries of one statute versus another.

A further suggested benefit of a single regulator is better communication and more coordination within the single agency as it regulates the two industries. This notion springs from the belief that separate regulators may fail to take account of the linkages between the markets under their respective authority and to assure full and prompt consideration of such matters. However, improved communication and coordination is not necessarily assured among components of a single agency and is not precluded by the independence of agencies. Rather, coordination depends upon attitudes and insights into linkages and mechanisms that have little relation to agency structure.

Over the past several years, both the CFTC and SEC have come to understand more completely the links between the two markets, and have cooperated in finding solutions for perceived inter-market problems. Indeed, the CFTC has actively sought to forge close relationships with all of the interested financial regulators.

For example, the Commission provides a monthly report to the banking regulators regarding the positions held by banks in the futures and options markets. In addition, the Commission's surveillance staff conducts quarterly meetings, which are attended by officials from the FRB, SEC, Treasury, and Federal Reserve Bank of New York (via teleconferencing), to identify and resolve inter-agency concerns relating to the expiration of financial futures contracts.

The CFTC also participates in meetings of groups designed to foster coordination of specific intra-market or inter-market regulatory or self-regulatory activities. These groups include the Working Group on Financial Markets, the Working Group on Treasury Market Surveillance, the Inter-market Surveillance Group, the Inter-market Financial Surveillance Group, the Joint Compliance Committee, the Clearing Organization and Clearing Bank Roundtable, the Joint Audit Committee, the Securities and Commodities

Fraud Working Group, the Telemarketing Fraud Working Group, and working groups established by the Market Improvements Committee (on which Commission staff participate as observers). Recent cooperative efforts between the CFTC and the SEC have resulted in companion orders facilitating cross-margining of index futures and options positions, as well as the on-line system for sharing aggregated settlement data and margin and deficit information on clearing members of all futures exchanges and the OCC.

Finally, it may be suggested that there could be some fiscal savings from a merger of regulators, a consequence of the economies of scale. Again, however, it is easy to overestimate these savings. Assuming that both agencies are generally efficient, the number of program staff needed to carry out the separate functions of the merged agency related to regulating the futures and securities markets would be the sum of the current program staffs of the independent agencies. Further, assuming that the number of support or administrative personnel is reasonably related to the level of program staff, the actual savings in overhead personnel would not be great. For example, many of the employees currently performing personnel functions for the CFTC would be needed to perform those same functions in the larger, merged agency. Furthermore, there are additional, potentially significant short-term costs associated with a merger, such as program disruption, the need to redraft many regulations and relocation costs. Accordingly, the actual savings realized from a merger may be quite modest.¹⁷⁹

There are also disadvantages which can be anticipated when examining whether the CFTC should be merged with another agency. When Congress created the CFTC in 1974 as an independent agency, it determined that the regulator for futures should not be incorporated within the agency regulating the underlying cash markets--at that time, the Department of Agriculture. This determination--that the futures industry was sufficiently important and complex that an agency regulating futures markets should have that

¹⁷⁹As a practical matter, the debate on merger should also consider the potential savings and efficiencies that would result if each agency retains its autonomy and carries out the recommendations of the Administration's National Performance Review program. In that regard, it should be noted that the CFTC has received approximately the same appropriation (\$47 million) in FY 1992, FY 1993, and FY 1994. To operate within the appropriated budget, the CFTC reduced its full-time employees ("FTEs") from 592 in FY 1992 to 562 in FY 1993, and is on target to meet further Office of Management and Budget FTE cuts in FY 1994 and FY 1995.

as its sole mission--was made at a time when only 87 exchange-designated contracts were trading at an annual volume of 27.7 million contracts.¹⁸⁰ Were the CFTC to be merged with another regulator today--with 182 contracts trading in 1992 at an annual volume of 364.5 million contracts--that clarity and focus of mission would become blurred even though the importance and complexity of the futures markets has increased dramatically.

For example, as an independent regulator, the CFTC naturally focuses its attention on each category of commodity futures: agricultural, precious metals, natural resources, and financials. Merger of the CFTC with another regulator might tend to reinforce the attention paid by the merged regulator to those markets common to both former organizations, at the expense of those markets, agricultural futures, for example, which were unique to one. Similarly, the SEC, also an agency with a clearly-defined mission, would likely have its clarity of focus diminished by such a merger as well.

A second disadvantage of merging the two regulators would be the loss of the competitive benefit which accrues from their independence. First, the decision-making of both could likely be slowed by creating a larger and more cumbersome structure. Secondly, the two agencies currently have the benefit of each other's experience. Merger into a single agency might diminish the opportunity for fostering innovative ideas that exists with two independent regulators.

For example, the CFTC has relied on the SEC's development of capital rules in formulating its own, and was guided by the SEC's Regulation D, 17 C.F.R. §230.501 et seq., in formulating the CFTC's reporting and disclosure requirements for commodity pools marketed exclusively to "qualified eligible participants." The SEC, in turn, for example, has taken note of the CFTC's performance-reporting requirements for pools in determining whether to modify its approach to performance reporting. Finally, the

¹⁸⁰See, S. Rep. No. 1131, 93rd Cong., 2d Sess. at 19 (1974):

It is apparent that a regulatory agency cannot be expected to oversee the rapidly expanding and complex futures markets without additional tools with which to do the job and proper organization and funding. . . . The importance of futures trading to the general public and to the Nation equals the importance of the securities markets. It is therefore time to establish a regulatory authority in the commodity field similar to the Securities and Exchange Commission and to give that authority a strong law which will enable it to regulate both agricultural and nonagricultural goods and services in the public interest.

concept of "circuit breakers" which are in place in both the stock index futures markets and the underlying stock markets are grounded in the traditional commodity futures markets use of maximum daily price limits.

Most importantly, a merger of the CFTC and SEC would leave unaddressed the emerging issues concerning the unregulated OTC derivative markets which are the primary focus of this report. A merged CFTC/SEC would likely face the same problems which the agencies now face separately regarding the increasing use of Derivative Product Companies ("DPCs"). In addition, because of the deepening involvement of the nation's banks in these OTC markets, any proposal to increase federal oversight of the OTC markets must consider including the banking regulators. In light of the increasing connections between all facets of the financial services industry, a merger limited to the CFTC and SEC likely would fail to confront the emerging issues of the marketplace, and instead, would address problems which have, by and large, already been resolved.

Conclusions and Recommendations

With regard to the trading of commodity futures and options contracts and securities products, the current regulatory schemes, with independent regulators for the futures and securities markets, work well. As discussed above, both agencies have responded flexibly to the rapid changes in their markets and with the growing interconnections between them. Both agencies have been coordinating their regulatory and enforcement activities to address common problems, while maintaining their ability to focus their attention on their own specialized missions. Further, to the extent that financial innovation produces new or different linkages between the marketplaces for futures and for securities, there are ample coordinating mechanisms and statutory powers, particularly the new CFTC exemptive authority, to address them. As a result, there appears to be no basis for, or little evidence to support, the proposition that the current CFTC/SEC frameworks or the manner in which they are administered would be improved by consolidation of the two agencies.

As noted elsewhere in this report, however, the issues raised by OTC derivatives are by no means limited to matters committed to the oversight of either the CFTC or the SEC. OTC derivatives products

encompass products unregulated under either regulatory framework. Further, the systemic implications of the OTC derivative marketplace relate to the aggregate effect of multiple products upon financial markets and to the responsibility of the bank regulators and other agencies charged with oversight of the activities of the entities involved in these markets.

Thus, the well-established cooperative relationship between the CFTC and the SEC in matters that cross jurisdictional lines does not alone answer the broader issues raised by the OTC derivatives markets. Many of the entities undertaking transactions in these OTC markets may be subject to a regulator either in connection with their primary businesses or their marketing of a specific instrument. Others may not be subject to any federal regulation.

On balance, the CFTC believes that fundamental structural changes are not yet needed to address the issues raised by these developing OTC markets, and that important benefits from the continued independence of the financial regulatory agencies would be lost were they to be consolidated. The principal regulatory agencies are moving ahead individually and in concert to address issues and concerns that have been raised about OTC derivatives.

The CFTC believes that there are legitimate cross-market concerns about OTC derivatives that could best be addressed on an inter-agency basis. For example, an inter-agency coordinating council might be beneficial in addressing the need for federal oversight of those entities currently in the OTC derivative markets which are not otherwise subject to federal regulatory oversight. Such a formal structure would supplement the agencies' current efforts at cooperation, information sharing, and harmonizing regulatory efforts. Over time, the existence and operation of such an inter-agency council would give a clearer idea of the number and relative importance of common issues versus issues specific to a particular financial regulator.